**APPENDIX A — CORRECTED ORDER OF THE COURT OF APPEALS OF MARYLAND DATED JULY 14, 2003**

COURT OF APPEALS OF MARYLAND

No. 80

September Term, 2000

COMPTROLLER OF THE TREASURY

v.

CROWN CORK & SEAL COMPANY (DELAWARE), INC.

**CORRECTED**

**O R D E R**

The Court having considered the appellee's motion for reconsideration filed in the above entitled case, it is this 14th day of July, 2003,

ORDERED, by the Court of Appeals of Maryland, that the motion be, and it is hereby, DENIED.

/s/ ROBERT M. BELL
Chief Judge

## APPENDIX B — OPINION OF THE COURT OF APPEALS OF MARYLAND DATED AND FILED JUNE 9, 2003

## IN THE COURT OF APPEALS OF MARYLAND

Nos. 76 & 80

September Term, 2000

COMPTROLLER OF THE TREASURY

v.

SYL, INC.

* * *

COMPTROLLER OF THE TREASURY

v.

CROWN CORK & SEAL COMPANY (DELAWARE), INC.

Opinion by Eldridge, J.

Filed: June 9, 2003.

These cases concern the liability for Maryland income taxes of two corporations that do no business in Maryland, and own no tangible property in Maryland, but are subsidiaries of parents that do business in Maryland. The dispositive issue is whether there is a sufficient nexus between the State of Maryland and each subsidiary

corporation so that the imposition of Maryland income tax does not violate either the Commerce Clause of the United States Constitution, Art. 1, Section 8, cl. 3, or principles of due process.

I.

This opinion encompasses two cases; consequently, we shall set forth the facts of each case separately.

A. No. 76, *Comptroller of the Treasury v. SYL*

SYL, Inc. is a Delaware corporation and a wholly owned subsidiary of Syms, Inc. SYL owns intellectual property assets used by Syms, specifically trademarks, trade names and advertising slogans.[1] SYL's primary function is to manage and control these intellectual property assets. Syms is a New Jersey corporation that sells men's, women's and children's clothing in numerous states, including Maryland.

Syms incorporated SYL in December 1986, and upon its formation, Syms assigned the above-described intellectual property assets to SYL. In return, SYL granted to Syms a license to manufacture, use and sell the products covered by the trade names and trademarks in its business throughout the United States. In consideration for these intellectual property rights, Syms agreed to pay SYL a royalty based on the parent corporation's sales. At the same time that Syms created SYL, it also created another wholly owned subsidiary named SYI, Inc., the purpose of which was to give SYL investment advice.

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1. Hereafter in this opinion we shall use the term "trademarks" for all of the intellectual property assets.

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For the tax years 1986 through 1993, SYL did not file corporate income tax returns in Maryland. Throughout this period, SYL did not own or lease tangible property in Maryland, had no employees in Maryland, and maintained no bank accounts in Maryland. Nor did SYL directly sell or lease goods or services in Maryland through advertising, mailings, or in-person solicitations. Syms, however, did have extensive business contacts in Maryland during this time period through its ownership and operation of retail stores in Maryland. Syms regularly filed Maryland corporate income tax returns.

In 1996, the Comptroller issued a Notice of Assessment to SYL, indicating that SYL owed for the years 1986 through 1993 an amount of $637,362 in corporate income taxes, including interest and penalties. SYL timely protested the Comptroller's Notice of Assessment. After a hearing, the Comptroller, by a hearing officer, issued a Notice of Final Determination that sustained the Notice of Assessment. The hearing officer, *inter alia*, found as follows:

> "In general, the Comptroller's Office assessed SYL, Inc., a tax-haven entity earning substantial related party income, based on the position that SYL, Inc. ('SYL') was a phantom entity that did not have substantial economic substance. The Comptroller's audit section concluded that SYL's lack of substantial substance and its dependence on Syms Corporation ('Syms') for its earnings required SYL to file returns with Maryland based on the apportionment factor of its parent company Syms. The Comptroller's audit section relied upon

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*Comptroller v. Armco*, 572 A.2d 562 (1990) (cert.denied); *Comptroller v. Atlantic Supply Co.*, 448 A.2d 955 (1982). The Comptroller's Office believes these decisions are consistent with Tax-General Article, Section 10-402 which generally requires that the income reasonably and fairly attributable to carrying on business in Maryland be taxable by Maryland. In short, the Comptroller's section found SYL to be a phantom or bookkeeping entity and taxed it based on economic reality and the true source of its income."

* * *

"In December, 1986, Syms incorporated SYL in Delaware and putatively assigned to SYL its ownership in trademarks. As part of an overall plan, SYL licensed back to Syms the trademarks and ostensibly assumed (at least on paper) all obligations for management and administration of the marks. Just as before the assignment and simultaneous license back of the marks, Syms continued to utilize the marks in its retail clothes stores in Maryland and other states. SYL charged Syms a 4% royalty pursuant to a license agreement which was apparently entered into on December 18, 1986 (though dated July 1986). The 4% royalties were charged from October 1, 1986 even though the formal assignment of the intangibles was not effectuated until December 19, 1986. Moreover, the valuation of the arm's length royalty

rate was provided by a company which was engaged by a consultant (Coventry Financial Corp.) which apparently was provided a financial stake in the tax savings obtained.

"At least one significant objective of forming SYL was to generate state income tax benefits. See memorandum of Karen Artz Ash dated July 22, 1986 at p. 6. See also Rosen, 'Use of a Delaware Holding Company To Save State Income Taxes', 20 *Tax Advisor* 180 (1989). Significant state income tax savings were generated from SYL in Maryland and other separate return states because (a) Syms deducted the substantial royalty payments of roughly $12 million each year to SYL and (b) SYL did not report its royalty income as taxable in Maryland or other separate return states other than Delaware. Since Delaware does not generally tax income from intangibles, SYL generated very substantial state income tax benefits. It appears from one document (finally obtained after repeated requests) that Syms paid a third party — Coventry Financial Corp. — a percentage of the early year state tax savings for its consulting efforts in setting up SYL. See the Richard Diamond to Sy Syms memorandum dated December 12, 1986 entitled 'State Income Tax Savings — Coventry Financial Corp.' "

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"While by no means exhaustive, I find some of the salient and controlling facts as follows:

"(1) SYL was a thinly constituted entity with very little if any true economic or operational activity in that:

"(a) It paid out very little in wages and the $1,200 or so of yearly wages paid were to employees of third party 'nexus service providers' which are in the business of providing tax-haven entities with 'apparent substance'. SYL contracted with one such 'nexus service provider' which provides mail forwarding, shared office space and shared employees for numerous other taxpayers. At least some nexus service providers promote their services to potential clients at tax seminars, and it is understood that hundreds, if not thousands, of taxpayers enter into arrangements with these nexus service providers.

"(b) SYL had no separate office or employees other than the shared space and purported employees of nexus service providers and the officers of Syms who were compensated solely by Syms.

"(c) SYL had no phone listing, phone service or office signage.

"(d) SYL apparently did not license its marks (or attempt to license) to third parties.

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"(e) SYL officers did not have business cards, job descriptions, job evaluations or other indicia of a true employment relationship.

"(f) Though requested, SYL could not produce invoices issued to Syms pursuant to the royalty agreement (beyond the initial billing period).

"(g) Though requested, SYL could not produce travel reports showing business activity in Delaware.

"(h) Though requested, SYL failed to produce a person at the informal hearing who could speak to any activities being conducted by SYL."

* * *

"From a legal standpoint, it is difficult to find fault in the Comptroller's assessment. As in *Armco*, the Comptroller's Office appropriately determined that the factors and attributes of Syms should determine how SYL's income should be taxed. Since SYL was found to be a phantom, it was clearly appropriate to look to the true underlying source of its income. SYL's booked income was in reality generated from Syms' sales, property and payroll.

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> "It was Syms' use of the marks, its goodwill and its efforts in Maryland and elsewhere which gave the marks value and generated the income 'booked' in SYL."

SYL appealed the assessments to the Maryland Tax Court, with its "Petition of Appeal" headed "SYL, INC. c/o Syms Corporation[,] Syms Way[,] Secaucus, New Jersey 07094 v. Comptroller of the Treasury." SYL's petition alleged, *inter alia*, that it was a Delaware corporation "organized in 1986 by its parent, Syms Corp. . . . to hold certain registered trademarks and trade names," that SYL had "as a valid business purpose the protection, maintenance and management of valuable intangible assets," that SYL maintains an office in Delaware, a separate bank account, and has its own corporate officers and board of directors who meet regularly, that SYL "is a bona fide corporation with substantial corporate substance" and with "a valid business purpose," that the taxation of SYL's income is not authorized by Maryland Code (1988, 1997 Repl. Vol., 2002 Supp.), § 10-402 of the Tax-General Article, or by any other Maryland statute, and that the Comptroller's assessments violate the Fourteenth Amendment's Due Process Clause and the Commerce Clause of the United States Constitution. The Comptroller's answer denied SYL's allegations concerning its viability, valid business purpose, substance, etc., as well as SYL's legal conclusions under the Maryland statutes and the federal Constitution.

The parties thereafter entered into a stipulation setting forth the procedural history of the case, the basic facts concerning Syms's operations in Maryland, the fact that SYL

is a wholly-owned subsidiary of Syms, and SYL's lack of property, employees, or bank accounts in Maryland. The stipulation also agreed upon the introduction into evidence of twenty-eight exhibits which were attached. In addition to the numerous exhibits which were introduced, the Tax Court held a hearing extending over two days during which several witnesses testified. The administrative record discloses the following information about the creation and operation of SYL.

The suggestion to create SYL for tax benefit reasons originated from Coventry Financial, a consulting firm which approached Syms Corp. in June of 1986. Upon the creation of SYL as a trademark holding company, and SYI, Inc., as a second wholly-owned subsidiary which would act as an investment advisor to SYL, Syms Corp. was to assign the trademarks to SYL and SYL was to license the trademarks back to Syms. Then, Syms was to pay SYL a royalty for the use of the trademarks, which SYL was to keep temporarily before the funds were sent back to Syms as a dividend payment. In the interim, SYL was to invest the funds, with SYI controlling the investment decisions. Coventry Financial's fee was directly tied to the total amount of tax savings generated from the implementation of its so-called "program."

One of Syms's inter-company documents stated that, once SYL received the royalty payments, SYL was to hold the payments in Delaware for "at least a couple of weeks." The document went on to explain that the payments would later be sent back to Syms in the form of a dividend in the same quarter to "avoid any variances on the financial

statements which may alert a state auditor to this transaction." Furthermore, a memorandum outlining the Syms-SYL transaction, written by Richard Diamond, Syms's Secretary-Treasurer, to Syms's Chief Executive Officer, Sy Syms, stated that, while the royalty payment funds were being held temporarily in Delaware, it was "necessary" for SYI to be the investment advisor. The memorandum further stated that "it is necessary that it do[es]n't appear that the investment decisions are being made by Syms Corp." Notwithstanding this statement, three of the four officers of SYI were officers of Syms. On cross-examination, Mr. Diamond acknowledged that this "was one of Coventry's ideas to sort of distance SYL from Syms Corp. in terms of investing the money; to help in terms of the tax aspects of this transaction." He further acknowledged:

> "Q. So would you agree that it was an idea that was designed to keep tax auditors from realizing what was going on?
>
> "A. From — yes. From the tax part of it, yes."

Mr. Diamond later reiterated that, "just from a tax point of view . . . I felt it was advantageous to create some distance between Syms Corp. and SYL."

SYL used the services of Gunnip & Company to establish a presence in Delaware. Among other things, Gunnip offered SYL a "Delaware address" and "mail forwarding." Additionally, a letter from Gunnip to Mr. Diamond advises that the total $2400 per year fee paid to Gunnip "could be billed to [SYL] as rent monthly $100.00 and . . . as salary

quarterly $300.00." Actually, SYL's Delaware "office" lacked a phone listing, had no office sign, and no business cards. SYL's Board of Directors consisted of four people: (1) Sy Syms who, as previously mentioned, was Syms's Chief Executive Officer; (2) Marcy Syms who was Syms's Chief Operating Officer; (3) Richard Diamond who was Syms's Secretary-Treasurer and Chief Financial Officer; and (4) Edward Jones who was an accountant with Gunnip. Jones also was SYL's only "employee," and, out of the $2400.00 annual fee paid to Gunnip, $1200 annually was designated as Jones's "salary."

Mr. Diamond testified that SYL hired outside trademark counsel to handle the protection of the trademarks. Nonetheless, on SYL's financial statements, no legal expenses were listed on any of the unaudited profit and loss statements submitted. Mr. Diamond explained that they "were probably paid for by Syms Corp." and that "[i]t didn't make a difference overall." In fact, nothing substantial appears to have changed with respect to the management and administration of the trademarks after the formation of SYL. During the cross-examination of Karen Ash, Syms's and SYL's outside trademark counsel, the following ensued:

> "Q. Was there any difference whatsoever in the work performed by your law firm prior to and subsequent to the assignment of these marks from Syms to SYL?
>
> "A. No.

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"Q. You continued to do the same thing?

"A. Yes.

"Q. If a mark needed to be registered you took to registering it? If an infringement was suspected, your firm would take the appropriate action, correct?

"A. Correct."

Although the business purpose alleged for the formation of SYL was the "maintenance and management of valuable intangible assets," the license agreement between Syms and SYL authorized Syms to take charge of such maintenance and management. It stated: "Licensor [SYL] shall have the right (but not the obligation) to take charge of the defense of any [infringement] claim, action or proceeding. . . . If licensor declines . . . to defend any such claim, action or proceeding, licensee may do so." The license agreement did impose some affirmative duties upon SYL, as licensor, in the area of quality control of the trademarks. Nevertheless, there is no indication in the record that Edward Jones, SYL's sole "employee," performed any of these duties. Nor are the quality control duties mentioned in the letter memorializing the services that Mr. Jones was to provide to Syms or SYL. Instead, according to the testimony, these duties were assumed by Syms's officers when they were wearing their SYL "hats." Additionally, the license agreement imposed upon Syms the duty to "deliver to Licensor a statement certified by the financial officer of Licensee showing a computation of Net

Sales and the amount of royalty payable hereunder." The record discloses that no certified financial statements were ever provided to SYL.

SYL's cash receipts and disbursement journals fail to reveal any evidence of the economic substance of that corporation. In the relevant time period, SYL paid no costs associated with the protection of the trademarks, *i.e.*, no costs to register the trademarks, no legal fees associated with the trademarks, and no telephone expenses associated with any discussion of the trademarks, since SYL apparently did not have a telephone. A study of SYL's financial statements reveals that, in some years, the royalties owed were never received. Finally, although "facilitating the franchising of the Syms trade name to third parties" was one of the primary reasons for the formation of SYL, the trademarks were never licensed to anyone but Syms Corp.

The Maryland Tax Court, which is an administrative agency,[2] in April 1999 issued an order reversing the assessments levied by the Comptroller. In an accompanying opinion, the Tax Court incorporated by reference and quoted extensively from its opinion in another case, *MCIIT v. Comptroller*, Tax Court No. C-96-0028-01 (1999), stating that the analysis and applicable law in the two cases were the same.[3] The Tax Court pointed out that the parent

2. *See Shell Oil Co. v. Supervisor*, 276 Md. 36, 38, 343 A.2d 521, 522-523 (1975).

3. A judicial review action in the *MCIIT* case, presently pending before this Court, has been stayed under the automatic stay provisions of federal bankruptcy law. *See* 11 U.S.C. § 362(a).

corporation and the subsidiary were operating as a "unitary" business, that the Comptroller, relying upon *Comptroller v. Atlantic Supply Co.*, 294 Md. 213, 448 A.2d 955 (1982), and *Comptroller v. Armco*, 82 Md. App. 429, 572 A.2d 562, *cert. denied*, 320 Md. 634, 579 A.2d 280 (1990), *cert. denied*, 498 U.S. 1088, 111 S.Ct. 966, 112 L.Ed.2d 1052 (1991), asserted that the subsidiary lacked "substantial economic substance," and that, therefore, the subsidiary had a "sufficient nexus" with Maryland through the operations of the parent in Maryland so that Maryland could constitutionally tax an appropriate portion of the subsidiary's income. The Tax Court then stated that the *Atlantic Supply* and *Armco* holdings applied only when the subsidiary had no economic substance whatsoever, and that "we conclude that Petitioner [SYL] is an entity of substance and not a 'phantom.' The Tax Court continued:

> "In the instant case, the evidence clearly indicates that Petitioner is not just a book entry corporation. Petitioner maintains an office in Delaware. That office contains office furniture and corporate and financial records are kept there. Mail is received at the Delaware office location. It has its own bank account and has an employee. Legal counsel was retained by Petitioner for purposes of protection its 'marks'. The requisites for corporate existence were met; i.e., the drafting of by-laws, the election of a board of directors and corporate officers, the holding of regular and annual meetings, the recording of corporate minutes, and the ratification of dividends.

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"Respondent claims that Petitioner 'was little more than a corporate vehicle designed to reduce state income taxes', (Respondent's Memorandum, p. 40), and points to the minimal expenses, the one employee, the mere formality of the corporate existence of Petitioner, and the timing of inter-entity transactions as support that petitioner was creating the 'illusion of substance', (Respondent's Memorandum, p. 31). In short, Respondent assessed on the basis that the Petitioner was a sham entity for the sole purpose to avoid Maryland taxes.

"Even if that were true, *Armco* and *Atlantic Supply* only apply to entities with no substance whatsoever. In addition, it is well settled that tax avoidance (rather than tax evasion) is a legitimate business purpose. If Petitioner was legally created with a tax avoidance purpose, absent authority and in a separate return environment, the Respondent cannot tax it. However, the evidence presented leads to the conclusion that Petitioner was established for non-tax reasons, among them:

- To hold and manage intangible assets in a separate corporation;

- To protect the transferred intangibles from the claims of Syms' creditors and from liabilities of Syms;

- To incorporate in a favorable corporate jurisdiction;

- To avert hostile take-overs; and

- To protect and enhance the value of Syms' name and its borrowing and business acquisition ability.

These facts easily distinguish the Petitioner from the phantom taxpayers in *Armco* and *Atlantic Supply.* Nexus cannot be attributed to it for Maryland taxation purposes."

Later the Tax Court concluded:

"Focusing solely on Petitioner, we find that its lack of in-state activity precludes the imposition of the tax. Petitioner is not doing business in Maryland. Its income producing activity all occurs outside of Maryland. Petitioner has no offices, employees, agents or property in Maryland. Its only Maryland contact is an affiliation with an entity with a Maryland presence. This affiliation is hardly enough to satisfy substantial nexus.

"Respondent relies on *Armco* and *Atlantic Supply* as support for the application of nexus due to the presence of Syms in Maryland. That reliance has been shown above to be erroneous. Respondent then points to the decision of *Geoffrey, Inc.*

*v. South Carolina Tax Commission*, 313 S.C. 15 (1993) as precedent in the taxing of a Delaware holding company licensing trademarks and trade names to its parent in-state company. The *Geoffrey* Court concluded that the use of intangible property (the 'marks') by the in-state affiliate was sufficient to pass the constitutional nexus requirements in order to tax the out-of-state entity. * * * [A]s indicated above, we differ in our conclusions as to whether the substantial nexus requirement of the Commerce Clause was met. *Geoffrey* focused on the use of the marks by the in-state affiliate of the unitary group in order to determine the nexus of the foreign corporation. We disagree that that activity constitutes 'substantial' nexus.

"In addition, the unitary relationship between entities does not automatically establish nexus on all of the corporate entities in the unitary group."

The Tax Court also addressed an alternative argument by SYL, although pointing out that the court's constitutional holding rendered the issue moot. The court agreed with SYL that, under *CBS v. Comptroller*, 319 Md. 687, 575 A.2d 324 (1990), the Comptroller should have promulgated a regulation before attempting to tax a portion of the income of subsidiaries like SYL.

The Comptroller filed in the Circuit Court for Baltimore City an action for judicial review of the Tax Court's decision, and the Circuit Court affirmed the decision. The Comptroller took an appeal to the Court of Special Appeals. Before

argument in the intermediate appellate court, this Court issued a writ of certiorari. *Comptroller v. SYL*, 360 Md. 485, 759 A.2d 230 (2000).

B. No. 80, *Crown Cork & Seal Company (Delaware), Inc. v. Comptroller of the Treasury*

Crown Cork & Seal (Delaware) (hereafter referred to as "Crown Delaware"), is a Delaware corporation and a wholly owned subsidiary of Crown Cork & Seal Company, Inc., (hereafter referred to as "Crown Parent"), also a Delaware corporation. Crown Delaware is the owner of certain intellectual property assets, namely thirteen domestic patents and sixteen trademarks. Crown Delaware's purported function is to manage and control these patents and trademarks. As set forth in a stipulation of facts filed in the Maryland Tax Court, Crown Parent is a corporation "engaged in the manufacturing and sale of metal cans, crowns, and closures for bottles, can-filling machines, and plastic bottles and containers, world-wide, including in the State of Maryland."

For the tax years 1989 through 1993, Crown Delaware did not file corporate income tax returns in Maryland. Crown Delaware did not directly own or lease tangible property in Maryland, had no employees in Maryland, and maintained no bank accounts in Maryland. It did not sell or lease goods or services in Maryland, did not advertise in Maryland, and engaged in no mailings or solicitations to persons or entities in Maryland. As both parties agreed in the stipulation filed with the Tax Court, Crown Parent did engage in extensive business in Maryland during this time period, as it operated

manufacturing plants in Baltimore City, Harford County and Wicomico County, and marketed its products in Maryland. Crown Parent timely filed Maryland corporate tax returns for this period.

In 1996, the Comptroller of Maryland issued a Notice of Assessment to Crown Delaware, stating that Crown Delaware owed for the years 1989 through 1993 Maryland corporate income taxes, including interest and penalties, in the amount of $1,421,034. Crown Delaware timely protested the Comptroller's Notice of Assessment. On February 25, 1997, the Comptroller issued a Notice of Final Determination that sustained the Notice of Assessment. The Notice of Final Determination was similar to the previously quoted notice in the SYL case. To summarize, the Comptroller upheld the assessment on the grounds that Crown Delaware was a "phantom company," a mere corporate shell with little economic substance and no independent source of income. According to the Comptroller, Crown Delaware was an alter ego of Crown Parent, designed to help Crown Parent avoid Maryland corporate income taxes. The Comptroller asserted that Crown Parent's royalty payments to Crown Delaware on intellectual property rights were a means of shifting income out of Maryland and into Crown Delaware's home State of Delaware. The Comptroller stated that, by piercing the corporate veil of this "bookkeeping entity," and taxing Crown Delaware based on the apportionment factor of Crown Parent, the State of Maryland would recover the income taxes to which it was entitled.

Crown Delaware took an appeal to the Maryland Tax Court, challenging the Comptroller's assessment. As in the

*SYL* case, Crown Delaware argued that the Comptroller was prohibited under the Commerce Clause of the United States Constitution, Art. 1, Section 8, cl. 3, from taxing it because Crown Delaware lacked a substantial nexus with the State of Maryland. Relying on the principle set forth in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 97 S.Ct. 1076, 1079, 51 L.Ed.2d 326, 331 (1977), that under the Commerce Clause a state tax is permitted when, *inter alia*, "the tax is applied to an activity with a substantial nexus with the taxing State," Crown Delaware asserted that there was no nexus in this case because it had no tangible property or business presence within Maryland. Crown Delaware also contended that the Comptroller erred in treating it as a "phantom corporation," asserting that it had employees, office space, and other corporate attributes that imbued it with sufficient economic substance, and that it was formed for the valid business purpose of protecting its parent's intellectual property assets. Finally, like the subsidiary in the *SYL* case, Crown Delaware contended that the Comptroller's attempt to tax it represented a change in policy which should have been accomplished by the promulgation of a regulation.

The Comptroller's arguments were essentially the same as in the *SYL* case. The Comptroller contended that there was a nexus between Crown Delaware and the State of Maryland, based on Crown Delaware's licensing of intangible property rights to its parent for use in products that were sold in Maryland. The Comptroller argued that Crown Delaware relied upon its unitary parent for its entire source of income, as Crown Parent's marketing to consumers of products based on Crown Delaware's licensed patents and trademarks was Crown Delaware's exclusive source of

royalty fees. In addition, the Comptroller analogized Crown Delaware to the "sham" subsidiaries involved in *Armco* and in *Comptroller v. Atlantic Supply Co.* The Comptroller pointed out that Crown Delaware lacked a separate office and employees from Crown Parent, did not exert a direct involvement in the control of the intellectual property assets which it was assigned, and did not conduct business activities on its own but, instead, relied on the business activities of Crown Parent. The Comptroller also asserted that the assessments did not represent a change in policy so as to require promulgation by a regulation.

The evidence before the Tax Court disclosed the following. Crown Delaware was incorporated in 1989, and Crown Parent assigned its intellectual property assets to Crown Delaware in exchange for all of Crown Delaware's issued stock. Crown Delaware then granted to Crown Parent an exclusive license, to continue from year to year unless terminated by either party, to manufacture, use and sell the products covered by these assets. In consideration for Crown Delaware's licensing of these intellectual property rights, Crown Parent agreed to pay Crown Delaware a royalty based on Crown Parent's sales.

In attempting to create a Delaware presence, Crown Delaware employed a third party, Organization Services, Inc. ("OSI"), "to facilitate the establishment of its business operations." OSI's brochure stated that it provided "complete services for corporations to minimize state taxes" through the use of various suggested subsidiaries. George P. Warren, the founder and president of OSI, described his company's function as "providing nexus services to Delaware Investment

Holding Companies." Among these "nexus services," the OSI brochure listed "discretionary mail forwarding." Additionally, the OSI brochure warned prospective customers as follows:

> "*Caution!*
>
> "A Delaware subsidiary must have substance to satisfy other states as to its situs within Delaware. This will include, but is not limited to, the following evidence of Delaware activity:
>
> Employees
> Personal income tax withholding
> Unemployment tax reporting
> Bank accounts and other assets
> Office space
> Furniture and equipment
> Stationery and business cards
> Books and records
> Director and stockholder meetings"

OSI provided these "nexus services" for about 400 other companies like Crown Delaware. Mr. Warren's duties as an "employee" of Crown Delaware were described by Crown Parent's general counsel as "do[ing] everything necessary basically in Delaware to comply with the law and regulations to give substance to this company as a viable and good company in Delaware."

Crown Delaware leased its corporate office space from OSI at the rate of up to $100.00 per month. In return, OSI provided "desk space" on a "part-time or full-time basis"

as well as conference rooms for meetings. Under the sublease agreement between OSI and Crown Delaware, OSI was to list Crown Delaware's name on one of the telephone numbers assigned to OSI in the Wilmington, Delaware "white pages" directory. OSI's address is listed on Crown Delaware's company checks.

Additionally, Crown Delaware hired OSI employees to manage its daily operations. Each of the nine part-time employees from OSI had a written employment agreement with Crown Delaware and was paid directly by Crown Delaware, which also withheld and remitted withholdings to the appropriate taxing authorities. A review of the employees' W-2 forms, however, reveals that the wages paid to these employees were insignificant in comparison with the ordinary labor costs incurred by a corporation earning revenue of over thirty million dollars per year. For example, in 1989, the total annual wages paid for the nine employees were $148.00; in 1990, $668 was the total amount paid in employee wages for the nine employees; in 1991, $562.64; for 1992, $623.79; and, finally, in 1993, the total amount of wages paid for all nine employees of Crown Delaware was $843.66. These employees were paid only once annually. These nine employees were clerical employees whose responsibilities never involved any intellectual property expertise.

George P. Warren, Jr., the president of OSI, is both an officer and director of Crown Delaware. Under the terms of his employment contract, Mr. Warren's salary for these services is $200 per year. Jane Warren, the Vice-President and Secretary of OSI, is also an employee of Crown

Delaware, as is Lee Lieberman, assistant secretary and assistant treasurer of OSI. OSI also serves as Crown Delaware's registered agent for service of process in the State of Delaware. The employment agreements define the "place of employment" as "any suitable location within the greater Wilmington metropolitan area."

Crown Delaware's balance sheets for the years in question reveal that, although the parent company made royalty payments to Crown Delaware, Crown Delaware immediately loaned the total payments back to its parent company. With regard to four of the five royalty payments in the relevant time period, the wire transfer records show that the royalty payments paid by Crown Parent were wired back to Crown Parent *on the same day*, creating an immediate circular flow. From 1989 to 1993, the debt owed by the parent company to Crown Delaware increased each year by the same amount as the royalty that the parent owed to Crown Delaware. As of 1993, there was no evidence in the record of the debt being paid. Nor does any loan agreement, stipulating to the terms of repayment or the sanctions in the event of default, appear in the record. Also notable was the fact that Crown Parent's 1991 royalty payment to Crown Delaware was paid on November 7, 1991, which was thirty-one days before Crown Delaware billed Crown Parent for the royalty payment and fifty-four days before the end of the year.

Moreover, for the years 1990 through 1993, despite having revenues that averaged around thirty-seven million dollars annually, Crown Delaware's actual operating costs averaged just over two thousand dollars per year. The regular

operating costs that inevitably arise in a normal business operation, such as meals and entertainment, telephone, and postage, were virtually non-existent on Crown Delaware's balance sheets. Over the five-year period in question, Crown Delaware incurred a total of twenty dollars in meals and entertainment, about sixty dollars in telephone charges, and about one hundred dollars in postage. Travel costs for the entire period in question amounted to less than seven dollars. Additionally, Crown Delaware's financial statements reported no depreciation for personal property.

Despite the fact that Crown Delaware's sole raison d'être was to manage its parent company's intellectual property, the subsidiary managed to avoid any and all legal fees associated with the patents and trademarks at issue. Following the creation of Crown Delaware, Crown Parent continued to use the services of the same two patent law firms that handled its intellectual property prior to Crown Delaware's creation.

Additionally, the patent and trademark license agreements disclose that Crown Delaware, the repository of this intellectual property, granted an *exclusive* license to its parent company. Accordingly, Crown Delaware could not license these intangibles to any other entity. Crown Parent, however, was entitled to do so, since the agreements authorized it to sub-license the intangibles to any third party. Furthermore, the licensing agreements imposed upon Crown Parent the responsibility of maintaining and defending the validity and ownership of these intangibles, as well as the general administrative duties of complying with all laws and regulations that may relate to them.

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The administrative record repeatedly shows instances where the formalities that normally serve to separate a parent corporation from its subsidiary were blurred. For example, there are instances where the terms "Crown Cork & Seal Company, Inc." and "Crown Cork & Seal Company (Delaware), Inc." are used interchangeably. There are also examples of Crown Parent's officers or directors signing documents as Crown Delaware's officers when in fact they are not officers; examples of Mr. Warren signing as Secretary of Crown Delaware when in fact he was not Secretary; or examples of the address of one entity being listed as the address of the other entity. In each instance, Crown Parent's general counsel explained that these examples were merely "screw-ups" or "mistakes."

As in the *SYL* case, the Tax Court issued an order reversing the assessments. In a brief opinion accompanying the order, the Tax Court "incorporated by reference" its opinion in *SYL*. While the Tax Court recognized that Crown Delaware and its parent were a unitary business, it rejected the attempt of the Comptroller to apply the holdings of *Atlantic Supply* and *Armco* to the taxation of Crown Delaware. The court expressed the view that the holdings of these two cases were limited to the taxation of "phantom" or "sham" subsidiaries with "no genuine economic substance." The administrative agency concluded that Crown Delaware had "economic substance," and held as follows:

> "Thus the factual resolution for the Court is whether nexus exists between Petitioner and Maryland. In order to meet Commerce Clause nexus requirements, there must be a 'substantial

nexus' with the taxing state. *Complete Auto Transit v. Brady*, 430 U.S. 274, 97 S.Ct. 1076 (1977). Petitioner does not own or lease property in Maryland. Petitioner has no employees, agents or offices in Maryland. Its income producing activity all occurs outside of Maryland. Crown Parent is the only contact Petitioner has with Maryland and that contact is not sufficient to meet the substantial [nexus] requirement.

"Nexus attributed to an out-of-state entity was found to be proper by the Maryland Courts only when the entities were true phantom corporations. . . . The evidence presented clearly shows that Petitioner is not a phantom or sham corporation. Petitioner is a viable entity established for valid business purposes, including the protection of valuable intellectual property rights from hostile takeovers of the parent corporation. Petitioner maintained an office in Delaware, met all corporate formalities, had separate bank accounts and employees performing services pursuant to written employment agreements."

The Comptroller filed in the Circuit Court for Baltimore City this action for judicial review of the Tax Court's decision, and the Circuit Court affirmed. The Comptroller filed an appeal to the Court of Special Appeals. Again, before argument in the intermediate appellate court, this Court

issued a writ of certiorari. *Comptroller v. Crown Cork & Seal Company (Delaware), Inc.*, 360 Md. 488, 759 A.2d 232 (2000).

II.

The controlling principles of Maryland income tax law and federal constitutional law, in cases like the instant ones, were recently summarized by Judge Rodowsky for this Court in *Hercules, Inc. v. Comptroller*, 351 Md. 101, 716 A.2d 276 (1998). First, with regard to federal constitutional limitations, the *Hercules* opinion stated (351 Md. at 109-111, 716 A.2d at 279-280, some internal quotation marks omitted):

> "Under both the Due Process and the Commerce Clauses of the Constitution, a State may not, when imposing an income-based tax, 'tax value earned outside its borders.' *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 164, 103 S.Ct. 2933, 2939, 77 L.Ed.2d 545, 552 (1983) (quoting *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315, 102 S.Ct. 3103, 3108, 73 L.Ed.2d 787, 794 (1982)).
>
> * * *
>
> "In order to levy a tax upon Hercules's capital gain from the sale of . . . stock, there must be some nexus linking this income to activities within the state. The necessary nexus usually 'is satisfied by demonstrating the existence of unitary business, part of which is carried on in the taxing state.'

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*NCR Corp. v. Comptroller of the Treasury*, 313 Md. 118, 132, 544 A.2d 764, 771 (1988). Where the nexus exists, the Maryland tax on a corporation engaged in a multistate business is governed by Maryland Code (1957, 1997 Repl.Vol.), § 10-402(c) of the Tax-General Article (TG), which requires that net income be apportioned to this state on the basis of a formula using property, payroll, and sales. *See Random House, Inc. v. Comptroller of the Treasury*, 310 Md. 696, 697, 701, 531 A.2d 683, 683, 685 (1987); *see also NCR Corp.*, 313 Md. 118, 141-42, 544 A.2d 764, 775; *Xerox Corp. v. Comptroller of the Treasury, Income Tax Div.*, 290 Md. 126, 129-30, 428 A.2d 1208, 1211 (1981); *accord Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 100 S.Ct. 1223, 63 L.Ed.2d 510 (1980).

* * *

"The Supreme Court has recently reemphasized its three-part test in determining whether a subsidiary is a part of the unitary business of the parent; those three elements are: (1) functional integration, (2) centralization of management, and (3) economies of scale. *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 783, 112 S.Ct. 2251, 2260, 119 L.Ed.2d 533, 549 (1992)."

Turning to the scope of § 10-402 of the Maryland Tax-General Article, the Court in *Hercules* reiterated (351 Md. at 110, 716 A.2d at 280, some internal quotation marks omitted):

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"The legislative purpose underlying this statute is to tax multi-state corporations doing business in Maryland to the bounds permitted by the United States Constitution. *NCR Corp.*, 313 Md. at 146, 544 A.2d at 777. To that end, the question before us becomes one of federal constitutional, rather than of Maryland statutory, law. In resolving that question, the burden is on the taxpayer to show 'by clear and cogent evidence' that [the state tax] results in extra-territorial values being taxed. *Container Corp.*, 463 U.S. at 175, 103 S.Ct. at 2945, 77 L.Ed.2d at 559-60."

In *NCR Corp. v. Comptroller of the Treasury*, 313 Md. 118, 131-132, 544 A.2d 764, 770-771 (1988), Judge Adkins for the Court explained:

"Apportionment under the unitary business formula, however, is not without its restrictions. The due process and commerce clauses do not allow states to tax a corporation's interstate activities unless there exists a ' "minimal connection" or "nexus" between the interstate activities and the taxing State, and "a rational relationship between the income attributed to the State and the intrastate values of the enterprise." ' *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 219-220, 100 S.Ct. 2109, 2118, 65 L.Ed.2d 66, 79 (1980) (quoting *Mobil Oil Corp. v. Comm'r of Taxes*, *supra*, 445 U.S. at 436-437, 100 S.Ct. at 1231, 63 L.Ed.2d at 520).

* * *

> "[The nexus p]rong . . . of the test is satisfied by demonstrating the existence of unitary business, part of which is carried on in the taxing state. Hellerstein, 'State Income Taxation of Multijurisdictional Corporations, Part II: Reflections on *ASARCO* and *Woolworth*,' 81 Mich.L.Rev. 157, 168 (1982) (hereinafter 'State Income Taxation'). Once the requisite nexus has been shown, the taxpayer then bears the burden of demonstrating that the income it seeks to exclude from taxation was derived from unrelated business activity that constituted a discrete business enterprise. *See Container Corp. supra*, 463 U.S. at 164, 103 S.Ct. at 2939-2940, 77 L.Ed.2d at 552; *Exxon Corp.*, *supra*, 447 U.S. at 223-224, 100 S.Ct. at 2120, 65 L.Ed.2d at 81; *Mobil Oil*, *supra*, 445 U.S. at 442, 100 S.Ct. at 1234, 63 L.Ed.2d at 524."

The *NCR* opinion, 313 Md. at 146, 544 A.2d at 777, went on to emphasize "that the goal of [the applicable Maryland statute] is 'taxation of so much of a corporation's net income as is constitutionally permissible,' " quoting *Xerox Corp. v. Comptroller*, 290 Md. 126, 142, 428 A.2d 1208, 1217 (1981).[4]

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4. House Bill 753 of the 2003 session of the General Assembly which passed both houses of the General Assembly but was vetoed by the Governor on May 21, 2003, concerned several provisions of the Maryland Code relating to taxation. A portion of the bill would have added language to § 10-402 of the Tax-General Article, apparently with the purpose of underscoring the scope of the section. The Governor's veto message stated in pertinent part:

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A case relied upon by the Comptroller, and distinguished by the Tax Court, SYL, and Crown Delaware, is *Comptroller v. Atlantic Supply Co., supra*, 294 Md. 213, 448 A.2d 955. In that case, Atlantic Supply Co. was a wholly owned subsidiary of the Macke Company, a vending machine company, with headquarters in Maryland and with wholly owned subsidiary vending machine companies in other states. Atlantic Supply was created as a wholesaler to purchase Coca-Cola products for the parent and various subsidiary vending machine companies because Coca-Cola refused to sell directly to retailers. Atlantic Supply had no separate place of business, no "office that [was] exclusively its own," no employees or payroll, and no bank account, although it had a post office box. 294 Md. at 217, 448 A.2d at 958. This Court held that the parent corporation and Atlantic Supply carried on a unitary business, and that (294 Md. at 223-224, 448 A.2d at 961)

> "Atlantic's trade or business operates exclusively within Macke's unitary business. Even though Atlantic must file a separate tax return, the particular nature of its business cannot be ignored. Atlantic's business could not function without the funds supplied by Macke-parent and without the Macke-branches as captive customers. Within the

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(Cont'd)

> "The changes to corporate income taxation include restrictions on Delaware Holding Company transactions. . . . Currently, the Comptroller is involved in litigation regarding this very issue. At this juncture, I believe it is prudent to wait until the Judiciary rules on the matter."

> framework of the kind of business it does, Atlantic enjoys the services of Macke-parent employees for Atlantic's clerical and accounting functions and the services of Macke-branch employees as Atlantic's buying and selling agents. Those employees worked in Macke's unitary business. . . . Those individuals in the general employ of Macke-parent and of the Macke-branches, who conducted the business of Atlantic, were sufficiently related with Atlantic, through Macke's unitary business, to permit Atlantic to apportion its income."

This Court held that the portion of Atlantic Supply's income that was attributable to Maryland was subject to Maryland income tax. Nevertheless, no argument had been made in the *Atlantic Supply* case that all of that subsidiary's income should be exempt from Maryland income taxes.

More pertinent is the opinion of the Court of Special Appeals in *Comptroller v. Armco, supra*, 82 Md. App. 429, 572 A.2d 562. That case involved three separate manufacturers doing business in Maryland (Armco, Inc., General Motors, and Thiokol), each of which created a wholly owned sales subsidiary known as a Domestic International Sales Corporation or DISC. The creation of such a subsidiary, as a device to encourage exports, had tax advantages under the federal Internal Revenue Code. Judge Getty for the Court of Special Appeals in *Armco* explained the federal tax advantages as follows (82 Md. App. at 430-431, 572 A.2d at 563-564):

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"By definition, a sales DISC (I.R.C., § 992(a)(1)(A)), earns income because it buys goods from its parent company and then resells the goods to an actual overseas customer; a commission DISC earns its income by a contractual agreement with its parent company giving it a percentage of each qualifying export sale made by the parent (I.R.C., § 992(a)(1)(C)). In either case, no activity is performed by the DISC to earn the income.

"DISC income is taxable income, but if the DISC transactions meet the tests of I.R.C., §§ 991-997, a DISC pays no federal taxes. Instead, a percentage of its income is imputed to the parent company as a constructive taxable dividend; the balance is taxable to the parent when it is actually distributed as a dividend. In short, DISCs are an approved device designed to defer paying the full amount of tax due when the income is received. This artificial accounting between related corporations is an exception to the general rule, I.R.C. § 482, requiring transactions between parent and subsidiary corporations to be arms length dealing."

In the *Armco* case, the Comptroller had attempted to subject a portion of each DISC's income to Maryland income tax, but the Tax Court and the Circuit Court, as in the present cases, held that there was an insufficient nexus with Maryland so as to allow Maryland taxation under the Commerce Clause of the United States Constitution. As pointed out by the Court of Special Appeals (82 Md. App. at 435, 572 A.2d at 566), the DISCs.

> "herein persuaded the Tax Court that nexus to tax DISCs must come from Maryland property, payroll, or sales by the DISC itself. We think that reasoning is flawed due to the very nature of a DISC, which has no tangible property or employees and can only conduct its activity and do business through branches of its unitary affiliated parent."

In language that is equally applicable to the *SYL* and *Crown Delaware* cases, the Court of Special Appeals in *Armco* concluded (82 Md. App. at 436, 572 A.2d at 566):

> "The three key elements necessary for constitutional nexus were affirmatively established in each of these three DISC cases. They are:
>
> 1. The parent is engaged in business in Maryland.
>
> 2. The parent is unitary with the DISC.
>
> 3. The apportionment formula is fair.
>
> "Activity directly connected to the DISCs took place in Maryland in that the goods produced here and sold overseas generated the DISC income. That activity included assembly of vehicles by GM, production of rocket motors by Thiokol, and steel fabrication by Armco."

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The Court of Special Appeals in *Armco* held that a portion of each subsidiary's income, namely that properly attributable to activity in Maryland, was subject to Maryland income tax.

SYL and Crown Delaware, like the Tax Court and the Circuit Court, take the position that the holding of the *Armco* case applies only where the subsidiary lacks all substance or is a "phantom" corporation. SYL and Crown Delaware point to the Tax Court's conclusions that each of them has economic substance. Treating these conclusions as findings of fact, SYL and Crown Delaware argue that the findings are supported by substantial evidence and that, therefore, they are binding upon this Court in these judicial review actions.

Preliminarily, the basic facts in these two cases are undisputed. Moreover, neither case involves the situation where some factors point to one conclusion, other factors point to a contrary conclusion, and, therefore, a reviewing court should accord a degree of deference to the balance struck by the administrative agency as trier of facts. *Cf. Ramsay, Scarlett & Co. v. Comptroller*, 302 Md. 825, 834-839, 490 A.2d 1296, 1300-1303 (1985); *Baltimore Lutheran High School v. Employment Security Administration*, 302 Md. 649, 663-664, 490 A.2d 701, 709 (1985); *Comptroller v. Haskin*, 298 Md. 681, 692-694, 472 A.2d 70, 76-77 (1984). Under circumstances like those in the present cases, where the facts before the administrative agency were undisputed, the legal conclusion based on those facts has been treated as an issue of law. *See, e.g., Comptroller v. Gannett*, 356 Md. 699, 707, 741 A.2d 1130, 1134-1135 (1999); *Hercules v. Comptroller, supra*, 351 Md. at 110, 716 A.2d at 280; *State Department v. Consumer Programs*,

331 Md. 68, 72-76, 626 A.2d 360, 362-365 (1993); *Comptroller v. Atlantic Supply Co.*, *supra*, 294 Md. at 218-221, 448 A.2d at 958-960.[5]

The records in these cases demonstrate that SYL and Crown Delaware had no real economic substance as separate business entities. They resembled the subsidiaries involved in the *Armco* case, except that SYL and Crown Delaware had a touch of "window dressing" designed to create an illusion of substance. Neither subsidiary had a full time employee, and the ostensible part time "employees" of each subsidiary were in reality officers or employees of independent "nexus-service" companies. The annual wages paid to these "employees" by the subsidiaries were minuscule. The so-called offices in Delaware were little more than mail drops. The subsidiary corporations did virtually nothing; whatever was done was performed by officers, employees, or counsel of the parent corporations. The testimony indicated that, with respect to the operations of the parents and the protections of the trademarks, nothing changed after the creation of the subsidiaries. Although officers of the parent corporations may have stated that tax avoidance was not the sole reason for the creation of the subsidiaries, the record demonstrates that sheltering income from state taxation was the predominant reason for the creation of SYL and Crown Delaware. For a discussion of the nature of Delaware trademark-holding subsidiaries like SYL and Crown Delaware, *see* Glenn R. Simpson, *Diminishing Returns*:

5. Even if the ultimate conclusions were viewed as findings of fact, we would hold that the Tax Court's findings, that SYL and Crown Delaware had real economic substance, were unsupported by substantial evidence in light of the entire records.

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*A Tax Maneuver in Delaware Puts Squeeze on States*, THE WALL STREET JOURNAL, August 9, 2002, at p. A1. *See also*, Craig J. Langstraat and Emily S. Lemmon, *Economic Nexus: Legislative Presumption or Legitimate Proposition?* 14 Akron Tax J. 1 (1999).

In reality, SYL and Crown Delaware have no more substance than the subsidiary DISC corporations involved in the *Armco* case. Under the holding of *Armco*, with which we fully concur, an appropriate portion of SYL's and Crown Delaware's income was subject to Maryland income tax.

Other courts have also upheld the application of state income tax laws with respect to a portion of the income of out-of-state subsidiaries having the sole function of owning their parents' trademarks. In *Syms Corp. v. Commissioner of Revenue*, 436 Mass. 505, 506, 765 N.E.2d 758, 760 (2002), the Supreme Judicial Court of Massachusetts upheld the Commissioner of Revenue's "disallowance of deductions Syms had taken for royalty payments it had made to its wholly owned subsidiary, SYL, Inc." The description of the relationship between Syms and SYL, by the Massachusetts Supreme Judicial Court, is a perfect fit in one of the cases at bar (436 Mass. at 509, 765 N.E.2d at 762, footnote omitted):

> "SYL's corporate 'office' consisted of an address rented from Jones's Delaware accounting firm, for an annual fee of $1,200. The accounting firm provided this same service to 'a couple of hundred' other corporations that used Delaware subsidiary corporations to hold their intangible assets. Jones was not only a partner of the

accounting firm, he was SYL's only employee, serving in a part-time capacity for which he was paid $1,200 per year.

"The business operations of Syms did not change after the transfer and license-back of the marks. All of the work necessary to maintain and protect the marks continued to be done by the same New York City trademark law firm that had previously performed those services, and Syms (not SYL) continued to pay all the expenses attendant thereto. All efforts to maintain the good will and thus to preserve the value of the marks were undertaken by Syms, and all advertising using the marks was controlled and paid for by Syms or by a wholly owned Syms subsidiary formed solely to do advertising. The choice of which products would be sold under the marks, as well as the quality control of those products, remained the responsibility of the same persons who had done that work before the transfer — Sy Syms, himself, and the Syms staff of buyers."

The Massachusetts court continued (436 Mass. at 509-510, 765 N.E.2d at 762-763):

"Syms does not contest the validity of the 'sham transaction doctrine' and the commissioner's authority under that doctrine to disregard, for taxing purposes, transactions that have no economic substance or business purpose other than tax avoidance. It is a doctrine long established

> in State and Federal tax jurisprudence dating back to the seminal case of *Gregory v. Helvering*, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935)."

The court upheld the administrative finding "that the transfer and license back transaction had no practical economic effect on Syms other than the creation of tax benefits, and that tax avoidance was the clear motivating factor and its only business purpose." 436 Mass. at 511, 765 N.E.2d at 764.

The Supreme Court of South Carolina in *Geoffrey, Inc. v. South Carolina Tax Commission*, 313 S.C. 15, 19-20, 437 S.E.2d 13, 16 (1993), upheld the imposition of state income tax on a portion of the income of a Delaware trademark-holding subsidiary of Toys R Us which had stores in South Carolina, saying:

> "In our view, Geoffrey has not been unwillingly brought into contact with South Carolina through the unilateral activity of an independent party. Geoffrey's business is the ownership, licensing, and management of trademarks, trade names, and franchises. By electing to license its trademarks and trade names for use by Toys R Us in many states, Geoffrey contemplated and purposefully sought the benefit of economic contact with those states. Geoffrey has been aware of, consented to, and benefitted from Toys R Us's use of Geoffrey's intangibles in South Carolina. Moreover, Geoffrey had the ability to control its contact with South Carolina by prohibiting the use of its intangibles here as it

did with other states. We reject Geoffrey's claim that it has not purposefully directed its activities toward South Carolina's economic forum and hold that by licensing intangibles for use in South Carolina and receiving income in exchange for their use, Geoffrey has the 'minimum connection' with this State that is required by due process. *See American Dairy Queen Corp. v. Taxation and Revenue Dep't*, 93 N.M. 743, 605 P.2d 251 (1979); *AAMCO Transmissions, Inc. v. Taxation and Revenue Dep't*, 93 N.M. 389, 600 P.2d 841, *cert. denied*, 93 N.M. 205, 598 P.2d 1165 (1979).

"In addition to our finding that Geoffrey purposefully directed its activities toward South Carolina, we find that the 'minimum connection' required by due process also is satisfied by the presence of Geoffrey's intangible property in this State."

The South Carolina Supreme Court concluded as follows (313 S.C. at 23-24, 437 S.E.2d at 18): "We hold that by licensing intangibles for use in this State and deriving income from their use here, Geoffrey has a 'substantial nexus' with South Carolina."[6]

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6. The issue has also arisen in New Mexico, and the Court of Appeals of New Mexico in *Kmart Properties, Inc. v. Taxation and Revenue Department of the State of New Mexico*, N.M. Ct. App. Nov. 27, 2001, held that the income paid to the out-of-state trademark-holding subsidiary was subject to state income taxes. The New Mexico Supreme Court granted a petition for a writ of certiorari in

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We hold that a portion of SYL's and Crown Delaware's income, based upon their parent corporations' Maryland business, is subject to Maryland income tax.

III.

A final issue decided by the Tax Court was whether, under *CBS v. Comptroller*, *supra*, 319 Md. 687, 575 A.2d 324, the Comptroller was required to promulgate an administrative regulation as a condition precedent to the imposition of Maryland income tax upon portions of SYL's and Crown Delaware's income. The Tax Court stated that the promulgation of a regulation was required, but we disagree.

The *CBS* case involved a policy matter that had been delegated to the Comptroller. The Comptroller had adopted one particular policy regarding the matter, and later the Comptroller changed to a different policy. We held that, under such circumstances, the Comptroller's change should have been embodied in a new administrative regulation. The instant cases do not involve a policy matter that has been delegated to the Comptroller. Instead, under our cases, the income involved is taxable under the Maryland statutory

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the case, *Kmart Properties v. Taxation and Revenue Department*, 131 N.M. 564, 40 P.3d 1008 (2002), but the case has been stayed pursuant to the automatic stay provisions of the bankruptcy law, 11 U.S.C. § 362(a).

The same issue is now pending in the North Carolina courts, where the Wake County Superior Court has upheld an administrative decision against a trademark-holding subsidiary.

provisions to the extent permissible under the Commerce Clause and principles of due process. The issue is the sufficiency of a nexus between the income and the State of Maryland so as to permit the imposition of the tax under the United States Constitution.

In addition, even if it were pertinent, the case does not involve a *change* in the Comptroller's policy. Prior to the assessments in these cases, the Comptroller had no policy regarding the matter. The creation of wholly owned trademark-holding Delaware subsidiaries has been a fairly recent development.

There were other issues raised in these cases which the Tax Court did not reach. Consequently, we shall direct a remand to that administrative body.

*JUDGMENTS OF THE CIRCUIT COURT FOR BALTIMORE CITY REVERSED, AND CASES REMANDED TO THAT COURT WITH DIRECTIONS TO REVERSE THE ORDERS OF THE MARYLAND TAX COURT AND TO REMAND THE CASES TO THE TAX COURT FOR FURTHER PROCEEDINGS CONSISTENT WITH THIS OPINION. APPELLEES TO PAY COSTS.*

## APPENDIX C — OPINION OF THE COURT OF APPEALS OF MARYLAND DECIDED SEPTEMBER 13, 2000

## COURT OF APPEALS OF MARYLAND

**Comptroller v. Crown Cork**

**OPINION:**

Petition for Writ of Certiorari Granted on the motion of this court.

## APPENDIX D — MEMORANDUM OPINION OF THE CIRCUIT COURT FOR BALTIMORE CITY FILED MARCH 17, 2000

**IN THE**
**CIRCUIT COURT FOR**
**BALTIMORE CITY**

Case No. 24-C-99-002388 AA

CROWN CORK & SEAL (DELAWARE) INC.

Respondent

v.

COMPTROLLER OF THE TREASURY

Petitioner.

### MEMORANDUM OPINION

### STATEMENT OF THE FACTS

Crown Cork & Seal (Delaware) Inc. (hereafter "Crown Delaware") is a wholly owned subsidiary of Crown, Cork & Seal Company, Inc. (hereafter "Crown Parent"), a public corporation in the business of manufacturing and selling metal cans, crowns, and closures for bottles (plastic and glass), can filing machines and containers. Crown Parent owned and operated manufacturing plants in Maryland and timely filed Maryland corporate income tax returns for the years 1989 through 1993.

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Crown Delaware was formed in Delaware and Crown Parent contributed its trademarks and patents to Crown Delaware. The marks were licensed back to Crown Parent for an agreed upon royalty fee. As a result of the licensing arrangement, Crown Parent's Maryland income was reduced by the amount of the royalties paid to Crown Delaware.

Crown Delaware does not own or lease property in Maryland. It has no employees, agents or offices in Maryland. Its income producing activity ail occurs outside Maryland. Crown Parent is the only contact Crown Delaware has with Maryland.

On May 13, 1996, the Petitioner, Comptroller of the Treasury (hereafter "Comptroller"), entered an assessment of additional Maryland corporation income tax against the Respondent Crown Delaware $759,263 (plus penalty and interest) for the years 1989 through 1993, inclusive. Crown Delaware filed a timely petition for revision of the assignment, and the Comptroller held an informal hearing as required by Tax-General Article § 13-508(c). Following the informal hearing, the Comptroller issued a notice of final determination dated February 25, 1997, affirming the assessment as originally entered. The basis for the Comptroller affirming the assessment was that Crown Delaware did business in Maryland through its parent, Crown Parent and was, therefore, required to pay a reasonably apportioned income tax on its income. From the notice of the final determination. Crown Delaware appealed to the Maryland Tax Court.

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Following a two-day evidentiary hearing and extensive post trial briefing, the Tax Court filed an opinion and order on April 26, 1999, reversing the assessments, based on its view that the Commerce Clause of the Constitution prohibited the Comptroller from imposing a Maryland income tax on Crown Delaware.

From the order of the Maryland Tax Court, the Comptroller filed a timely petition for judicial review with this Court.

**STANDARD OF REVIEW**

The Tax Court is an administrative agency, and judicial review of its decisions occurs pursuant to State Government Article § 10-222 and 10-223. Under the applicable standard of review, the reviewing court does not sit as an independent fact-finder and will uphold the Tax Court's findings if they are supported by substantial evidence. " A reviewing court will reverse the decision of the Tax Court, however, if the agency erroneously determines or erroneously applies the law." *State Department of Assessments and Taxation v. Consumer Programs, Inc.* 331 Md. 68, 72 (1993).

In *United Parcel Service Inc. v. Comptroller,* 69 Md. App. 458 (1986), the Maryland Court of Special Appeals set forth the following three-step analysis for Circuit Court review of a Tax Court decision:

> 1. First, the reviewing court must determine whether the agency recognized and applied the correct principles of law governing the case.

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The reviewing court is not constrained to affirm the agency where its order is premised solely upon an erroneous conclusion of law.

2. Once it is determined that the agency did not err in its determination or interpretation of the applicable law, the reviewing court next examines the agency's factual findings to determine if they are supported by substantial evidence, i.e., by such relevant evidence as a reasonable mind might accept as adequate to support a conclusion. It is the agency's province to resolve conflicting evidence, and, where inconsistent inferences can be drawn from the same evidence, it is for the agency to draw the inference.

3. Finally, the reviewing court must examine how the agency applied the law to the facts. This, of course, is a judgmental process involving a mixed question of law and fact, and great deference must be accorded to the agency. The test of appellate review of this function is "whether . . . a reasoning mind could reasonably have reached the conclusion reached by the [agency] consistent with a proper application of the [controlling legal principles] *United Parcel Service Inc.,* 69 Md. App. 458 (1986).

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## ISSUES PRESENTED

The central issue for this Court to determine is whether the Maryland Tax Court erred inholding a Maryland Statute and/or case law does not permit the imposition of State tax on the income of an out-of-state affiliate of a Maryland parent corporation.

## APPLICABLE LAW AND DISCUSSION

As the reviewing court, this Court will follow the three step analysis as set forth by the Court of Special Appeals in *United Parcel Service Inc. v. Comptroller,* 69 Md. App. 458 (1986), for Circuit Court review of a Tax Court decision.

Applying the standard of review to the Tax Court decision in the instant case this Court will determine whether the agency recognized and applied the correct principles of law governing the case. In making this determination, this Court reviewed the legal basis for the Tax Court decision in the instant case. In making its determination of whether CD had the legally required nexus to be taxed by the Maryland Comptroller the Maryland Tax Court looked to the Tax General Article of the Annotated Code of Maryland, as well as, controlling case law. This Court will provide pertinent sections of the Tax Court's Opinion in the instant case as part of its review of the Tax Court's decision. The Court will begin its review with the Tax Court's finding on the issue of nexus.

*Appendix D*

## I. Nexus.

### 1. The Tax-General Article of the Annotated Code of Maryland

The Maryland Tax Court examined the application of the Tax General Article of the Annotated Code of Maryland to the issue of nexus in the instant case. On this issue, the Maryland Tax Court in the *MCIIT* case stated:

> Maryland imposes a tax on the taxable income of a corporation defined as "its Maryland modified income as allocated to the State . . ." § 10-301 of the Tax-General Article of the Annotated Code of Maryland. Maryland modified income of a corporation is its federal taxable income, adjusted by the Maryland additions and subtractions, §10-301 through 10-308 of the Tax-General Article of the Annotated Code of Maryland. The computation of the tax requires the corporation to allocate Maryland modified income "derived from or reasonably attributable to its trade or business in this State" § 10-402(a) of the Tax-General Article of the Annotated Code of Maryland. If the entity earns its income from in and out of the State, that income derived from instate business activities must be allocated to Maryland, 10-402(a)(1)&(2) of the Tax-General Article of the Annotated Code of Maryland. If the corporation is unitary, then a 3 factor apportionment formula is applied to its income in order to determine Maryland taxable income

of that corporation, 10-402(c) of the Tax-General Article of the Annotated Code of Maryland. Under subsection (d) of § 10-402, the Respondent [the Comptroller] may alter the allocation and apportionment of a corporation's income "to reflect clearly the income allocable to Maryland". Each corporate member of an affiliated group, even if unitary, is required to file a separate tax return to the Respondent [the Comptroller], § 10-811. . .

The parties both agree that Petitioner is a unitary group of entities. Accordingly, relying on precedent established in two Maryland Court decisions, *Comptroller of the Treasury v. Armco Export Sales Corp.*, 82 Md App. 429 (1990) and *Comptroller of the Treasury v. Atlantic Supply Co.*, 294 Md. 213 (1982), the Respondent [the Comptroller] asserted nexus over the Petitioner [MCIIT] based on in-state activity of an affiliate, MCIT. Respondent [The Comptroller] first determined that Petitioner [MCIIT] lacked "substantial economic substance", labeling Petitioner [MCIIT] as a "Phantom" corporation. As such Respondent [the Comptroller] determined that the cases cited permit the attribution of "nexus and apportionment factors of the company or companies actually engaging in any real activity to the phantom company." Notice of Final Determination (Petitioners' Exhibit #63).

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We disagree with the Respondent's [the Comptroller] nexus attribution to Petitioner [MCIIT]. Fundamental in both court decisions is the determination that the taxpaying entity was a shell or a phantom corporation with no economic substance. In *Armco*, the Court was faced with a statutorily created business known as a Domestic International Sales Corporation or DISC. The Court characterized the DISC as a "phantom book entry corporation created under federal tax laws..." In expounding on the phantom nature of a DISC, the Court of Special Appeals noted that the DISC performed "no activity . . . to earn income" *Armco* at 431; that "none of the DISC's had any tangible assets or employees anywhere; and that the DISC "can only conduct its activity and do business through branches of its unitary affiliated parent" *Armco* at 430, 435. In addition, the Court concluded there was a specific legislative intent to subject the DISC's to Maryland income taxation.

In *Atlantic Supply,* nexus was not an issue. The taxpayer was clearly doing business in Maryland. The Court's focus was the taxation of an affiliate created for the specific purpose of obtaining the favorable wholesale price from a major supplier, Coca-Cola, which its parent, Macke Company, as a retailer, could not acquire. Emphasis was placed on the fact that the employees of the out-of-state affiliates were authorized to, and did, act in the name of the

taxpayer outside of the state. In addition, the Court noted that the taxpayer's business "could not function without the funds supplied by Macke-parent and without the Macke branches as captive customers." *Atlantic Supply, supra* at 223. The Court concluded then that the taxpayer could apportion its income among the states in which it did business.

It is clear to this Court that the above holdings are limited in their scope. The entities involved lacked *any* economic substance, thus earning their "phantom" status. Respondent's attempt to impose that status on corporations with substance is not justified through *Armco* and *Atlantic Supply*. Indeed, in this technologically advanced era, it is not practical as well. It is conceivable that, for legitimate business purposes, a seemingly insignificant affiliate (i.e. one employee and/or one computer) can exist which generates substantial income yet have little or no expense. To attribute nexus solely on the basis that there is reliance on Maryland affiliates for some or all of that income expands the limited holdings of *Armco* and *Atlantic Supply* and ignores the reality that they are separate non-phantom entities required to report their income separately.

*MCIIT, supra*, pages 6-8.

The Maryland Tax Court concluded that the Appellate Courts' holdings *Armco* and *Atlantic Supply* were limited in

scope. In support of this conclusion the Tax Court stated "the entities involved lacked any economic substance, thus earning their 'phantom' status."

In applying the *Armco* and *Atlantic Supply* decisions to the instant case, the Maryland Tax Court held that "Respondent's (the Comptroller's] attempt to impose that status on corporations with substance is not justified through *Armco* and *Atlantic Supply*. Indeed, in this technologically advanced era, it is not practical as well." In support of this holding the Tax Court stated, "It is conceivable that, for legitimate business purposes, a seemingly insignificant affiliate (i.e. one employee or one computer) can exist which generates substantial income yet has little or no expense." The Tax Court also held, "to attribute nexus solely on the basis that there is reliance on Maryland affiliates for some or all of that income expands the limited holding of *Armco* and *Atlantic Supply* and ignores the reality that they are separate non-phantom entities required to report, there income separately.

The Tax Court also held that the application of *Armco* and *Atlantic Supply* to the instant case is justified only if Crown Delaware is a "phantom" corporation. The Tax Court then stated reasons why Crown Delaware is an entity of substance and not a "phantom" corporation. The first reason stated by the Tax Court was that in the instant case, the evidence clearly indicates that Petitioner is a viable entity established for valid business purposes, including the protection of valuable intellectual property rights from hostile takeovers of the parent corporation. As support for this finding the Tax Court referred to evidence presented to that

Court which indicated that Crown Delaware maintains an office in Delaware, met all corporate formalities, had separate bank accounts and employees performing services pursuant to written employment agreements. The Tax Court stated additionally, that Crown Delaware received royalty income from third parties (other than Crown Parent or an affiliate) during some of the years in controversy.

The Comptroller claimed that Crown Delaware "was little more than a corporate vehicle designed to reduce state income taxes", (Respondent Memorandum), and points to the minimal expenses, the one employee, the mere formality of the existence of Petitioner, and the timing of inter-entity transactions as support that Petitioner was creating the "illusion of substance", (Respondent Memorandum). In short, the Comptroller assessed on the basis that Crown Delaware was a sham entity for the sole purpose to avoid Maryland taxes.

The Maryland Tax Court stated that even if that were true, *Armco* and *Atlantic Supply* only apply to entities with no substance whatsoever. In addition, the Court stated that it is well settled that tax avoidance (rather than tax evasion) is a legitimate business purpose. They rationalized that if Crown Delaware was legally created with a tax avoidance purpose, absent authority and in a separate return environment, the Comptroller cannot tax it. The Maryland Tax Court concluded, however, that the evidence presented leads to the conclusion that Crown Delaware was established for non-tax reasons such as:

- To hold and manage intangible assets in a separate corporation;

- To protect the transferred intangibles from the claims of Crown Parents' creditors and from liabilities of Crown Parent;
- To incorporate in a favorable corporate jurisdiction;
- To avoid hostile take-overs;
- and To protect and enhance the value of Crown Parents' name and its borrowing and business acquisition ability.

The Maryland Tax Court stated that these facts easily distinguish Crown Delaware from the phantom taxpayers in *Armco* and *Atlantic Supply*. Therefore, nexus cannot be attributed to it for Maryland taxation purposes.

The Maryland Tax Court then looked to Crown Delaware's activities to determine whether nexus can be directly found. The *MCIIT* is applicable to the present facts in Crown Delaware:

> The limits on the taxing powers of a state are found in the Due Process and Commerce Clauses of the Constitution. The Supreme Court reviewed the requirements of both Clauses in *Quill Corp. v. North Dakota,* 504. S. 298 (1992).
>
> In Quill, the Court reiterated that the "Due Process Clause 'requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax,' and that the 'income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State"'. *supra* at p. 307,

*citations omitted.* Overruling prior holdings, the Court determined that the minimum contacts necessary to establish the jurisdiction to tax does not require actual physical presence in the state, but can be found "if a foreign corporation purposefully avails itself of the benefits of an economic market in the forum State", *supra* at p. 307.

The Supreme Court's analysis of the Commerce Clause begins with the requirements as set forth in its decision in *Complete Auto Transit. Inc. v. Brady,* 430 U.S. 274 (1977). *Complete Auto* provides a four-part test which must be satisfied in order for a tax to pass muster against a Commerce Clause challenge. A tax is sustained so long as the tax: "1) is applied to an activity with a substantial nexus with the taxing State, 2) is fairly apportioned, 3) does not discriminate against interstate commerce, and 4) is fairly related to the services provided by the State". *Complete Auto* at p. 279. In discussing the first prong of the test, the Supreme Court held that the "substantial nexus requirement is not, like due process' minimum contacts' requirement, a proxy for notice, but rather means for limited in-state burdens on interstate commerce. Accordingly . . . a corporation my have the `minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the "'substantial nexus' with that State as required by the Commerce Clause." *Quill* at p. 313. The Court reafirmed the "bright-line" test it established in

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*National Bellas Hess, Inc. v. Department of Revenue,* 386 U.S. 753 (1967), that a taxpayer must have a physical presence in the taxing state in order to satisfy the substantial nexus requirement of the Commerce Clause.

In addressing the stricter "substantial nexus" requirement, Petitioner argues that since it has no physical presence in Maryland, the attempt to tax its income is a Commerce Clause violation pursuant to *Quill*. Respondent contends that the *Quill* Court explicitly noted that the physical presence requirement applies to sales and use taxes only.

Reliance is also placed on the *Armco* and *Atlantic Supply* decisions to support the application of an apportioned income tax to a corporation without any physical presence in Maryland.

The Respondent is correct in that the tax, the *Quill* Court analyzed, was a sales/use tax. The Court did note that "concerning other types of taxes we have not adopted a similar bright-line, physical presence requirement". 504 U.S. at p. 316. However, the Supreme Court also refused to restrict the rule to only sales and use taxes. "Although we have not, in our review of other types of taxes, articulated the same physical presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule", *supra* at

p. 314. This lack of clarity on the parameters of the physical presence test has led to differing interpretations among the States as to what the Commerce Clause requires in relation to income-based taxes.

Absent apparent explicit direction, we hesitate to expand the *Quill* physical present requirement to taxes other than sales and use. In so doing, however, we note that "substantial nexus" with the taxing state is still required in order to pass constitutional muster. In the rulings of *Armco* and *Atlantic Supply,* due to the nature of the corporate phantoms, with no substance and therefore, no presence anywhere, the normal nexus rules were ignored and the Courts found that nexus could be attributed based on the in-state presence and activity of an affiliate. The Commerce Clause was satisfied through the substantial nexus (the production and export of goods ) of the in-state unitary affiliate.

However, as stated above, the instant case does not present us with a phantom. Petitioner is an entity of substance with a presence somewhere and thus the normal nexus (versus nexus attribution) rules apply. The focus of the substantial nexus requirement is on the entity sought to be taxed, not its in-state affiliate.

*MCIIT, supra*, p. 9-11.

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The Maryland Tax Court found that Crown Delaware's lack of in-state activity precludes the imposition of the tax. The Tax Court reasoned that Crown Delaware is not doing business in Maryland because its income producing activity all occurred outside of Maryland. Furthermore, Crown Delaware had no offices, employees, agents or property in Maryland. Its only Maryland contact was an affiliation with an entity with a Maryland presence. This affiliation is hardly enough to satisfy substantial nexus.

Although the Comptroller relies on *Armco* and *Atlantic Supply* as support for the application of nexus due to the presence of Crown Parent in Maryland, the Tax Court held that that reliance is erroneous. The Comptroller then relied on *Geoffrey, Inc. v. South Carolina Tax Commission,* 313 S.C. 15 (1993) as precedent in the taxing of a Delaware holding company licensing trademarks and trade names to its parent in-state company. The *Geoffrey* Court concluded that the use of intangible property (the "marks") by the in-state affiliate was sufficient to pass the constitutional nexus requirements in order to tax the out-of-state entity.

The Maryland Tax Court disagreed with this analysis for two reasons. First, *Geoffrey* dealt with South Carolina law and its application and therefore, is not precedent for Maryland application. Second, as indicated above, the Tax Court differs in their conclusions as to whether the substantial nexus requirement of the Commerce Clause was met. The Tax Court went on to say that *Geoffrey* focuses on the use of the marks by the in-state affiliate of the unitary group in order to determine the nexus of the foreign corporation. The Tax Court held that the activity does not constitute a "substantial" nexus.

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In addition, the Maryland Tax Court stated that the unitary relationship between entities does not automatically establish nexus on all of the corporate entities in the unitary group. As they stated in *MCIIT, supra:*

> The mere presence of an in-state affiliate of a unitary group does not confer nexus on a non-phantom out-of-state affiliate of the same group. *Chesapeake Industries, Inc. v. Comptroller,* 59 Md. App. 370 (1984). In the unitary taxation scheme, the foreign corporation's income and factors may be included in determining the tax liability of the in-state affiliate. However, without nexus, the foreign corporation does not become subject to the taxing jurisdiction.
>
> The Respondent [Comptroller] claims that the corporate structure present here allows for the diversion of income away from Maryland through the internal transactions of affiliated entities which have no overall impact on the income of the unitary group. While this may be true, all such transactions are not necessarily abusive and in any event, these are the consequences of requiring affiliated corporations to file and report income separately. The Maryland Courts have addressed the treatment of such transactions when dealing with phantom corporations. With non-phantom corporations, such transactions when dealing with phantom corporations. With non-phantom corporations, such as Petitioner [MCIIT], the

> nexus rules as reiterated in *Quill* must still be applied to each affiliate before the State can tax.

*MCIIT, supra*, p. 11.

Accordingly, the Maryland Tax Court held that the Comptroller has failed to satisfy the substantial nexus requirement of the Commerce Clause and the imposition of income tax on Crown Delaware's income is unconstitutional.

This Court agrees with the Maryland Tax Court on the issue of nexus and reviewed the Crown Delaware Opinion under the three prong test set forth in *United Parcel Service Inc. v. Comptroller,* 69 Md. App. (1986). As to the first prong; this Court holds that the Maryland Tax Court recognized and applied the correct principle of law governing the Crown Delaware case.

Furthermore, as to the second prong, this Court examined the agency's factual findings to determine if they were supported by substantial evidence, i.e., by such relevant evidence as a reasonable mind might accept as adequate to support a conclusion. Where any inconsistent inferences that can be drawn, this Court gave deference to the agency's inferences, as required by *United Parcel Service Inc. v. Comptroller,* 69 Md. App. 458 (1986). This Court holds that the Maryland Tax Court's factual findings were supported by substantial evidence in the Crown Delaware case in reference to the nexus issue.

Finally, the third prong requires this reviewing Court to examine how the agency applied the law to the facts on the nexus issue.

> This, of course, is a judgmental process involving a mixed question of law and fact, and great deference must be accorded to the agency. The test of appellate review of this function is 'whether . . . a reasoning mind could reasonably have reached the conclusion reached by the [agency] consistent with a proper application of the [controlling legal principles].

*United Parcel Service Inc.* 69 Md. App. 458 (1986).

This Court has given the Maryland Tax Court great deference and holds that a reasoning mind could reasonably have reach the conclusion reached by the Maryland Tax Court in the Crown Delaware case in that there was no nexus between Crown Delaware and the State of Maryland.

**II. Regulation Promulgation Due to Change in Policy.**

Having agreed with the Maryland Tax Court's finding that the requisite nexus to warrant the imposition of income tax on Crown Delaware does not exist, the issue of whether a regulation had to be promulgated becomes moot. However, due to the number of taxpayers involved and the likelihood of judicial review, the Maryland Tax Court addressed this issue and this Court shall do so as well and in greater detail. This Court again will apply the three prong test as required under *United Parcel Service Inc.,* in its review of the Crown

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Delaware Opinion. *United Parcel Service Inc.* 69 Md. App. 458 (1986).

In short, this Court agrees with the Maryland Tax Court's holding that the Comptroller's attempt to assert tax on Crown Delaware amounted to a substantially new or change in policy and therefore, can only be instituted through rulemaking procedures as required by law, which makes the Comptroller's attempt improper. The Maryland Tax Court concluded that the Comptroller's attempt to assert tax against non-nexus, non-phantom trademark protection companies as a result of their licensing of the use of their trademarks, trade names and service marks to entities, which have a nexus with the State, amounts to a substantially new or change in policy, which can only be instituted through the rulemaking procedures pursuant to *CBS, Inc. v. Comptroller,* 319 Md. 687 (1990) and the Maryland Administrative Procedures Act. Md. Code Ann., State Gov't §§10-101 through 10-139. In *CBS Inc.,* the Maryland Court of Appeals held that a change in an agency's "policy of general application" which results in "materially modified or new standards" may be made by prospective rulemaking only. *CBS Inc.,* at 699. The Administrative Procedures Act requires that a change or implementation of policy by a State agency must be promulgated by regulation and that regulation may only be promulgated prospectively.

Furthermore, prior to 1995, companies such as Crown Delaware were not subject to tax, however, phantom companies like those found in *Armco* and *Atlantic Supply* were subject to tax. The Comptroller relied on ADR No. 2, title "Interstate Commerce Tax Act" — Domestic and Foreign

Corporation — Nexus Requirements — Apportionment of Net Income, published in 1989, to set forth parameters of taxing foreign corporations. However, the Maryland Tax Court held that nothing in that release, any regulation or statute, since 1989, suggest that a foreign corporation with substance but with no business location, representatives, or other activities within the State of Maryland could be subject to income taxes as a result of the licensing of the use of intangible "marks" to in-state entities.

Beginning in 1995, (subsequent to the issuance of the *Geoffrey* decision), the Comptroller began asserting deficiencies against foreign trademark protection companies based on the in-state activities of their affiliates. The Maryland Tax Court held that rather than a reflection of current policy, these assessments represented a change from its own stated policy (the 1989 Release) and those that affirmed *Armco* and *Atlantic Supply*. The Tax Court further held that that change "materially modified" existing jurisdiction to tax standards to the detriment of taxpayers which had relied on the Comptroller's past pronouncements. No regulations were promulgated or legislation enacted to effect this change in policy and, pursuant to *CBS, Inc.*, any retroactive attempt to tax Crown Delaware is improper. Furthermore, the Tax Court held that the Comptroller apparently believed that a regulation was necessary to expand the *Armco* policy as evidenced by the attempt to promulgate regulations relating to payments made by a Maryland taxpayer for "marks" from a contractor to an out-of-state affiliated entity. That attempt was rejected by the legislature and a review of their comments demonstrated that the

retroactive application of the Comptroller's policy was unacceptable per the Maryland Tax Court and this Court affirms that decision and reasoning.

In addition to agreeing with the Maryland Tax Court's analysis of *CBS* above, this Court extends the analysis of this issue by expanding the analysis in more detail. As stated in *CBS,*

> a number of [cases indicate that this requirement of rulemaking] adds an aspect of fairness when an agency intends to make a change in existing law or rule. That fairness is produced by prospective operation of a new rule and by the public notice, public hearing, and public comment processes that accompany rulemaking, but that are sometimes absent from administrative adjudication. *Cooperman,* 209 N.I. Super. at 201-202, 507 A.2d at 268-269. *See also* K. Davis, Administrative Law Treatise, §7:25, at 119 (2d ed. 1979) ("As a means of making new law, rulemaking is superior to adjudication in two main respects: (1) It is normally prospective, . . . and (2) rulemaking procedure may allow participation of nonparties who may be affected . . .")' *Bonfield, supra*, at 168-180; *Shapiro.* The Choice of Rulemaking or Adjudication in the Development of Administrative Policy, 28 Harv. L.Rev. 921, 930-972 (1965). The advantage of rulemaking in certain circumstances reinforce the view that this procedure may sometimes be required. We do not attempt to make an all-encompassing statement

> of what those circumstances may be. But we do conclude, as did the Attorney General in 1980, that when a policy of general application, embodied in or represented by a rule, is changed to a different policy of general application, the change must be accomplished by rulemaking. *See* 65 Op. Att'y Gen. 396, 404-406 (1980). That is the sort of change that occurred here, as the Tax Court's fact-finding indicates."

*CBS, Inc.*, at 695-696.

Applying the Maryland Tax Court's findings, as well as reviewing *CBS* separately, this Court agrees with the Maryland Tax Court on the issue of whether the Comptroller's assessment amounts to a substantially new or change in policy which can only be instituted through the rulemaking procedure pursuant to *CBS, Inc.* and the Maryland Administrative Procedures Act. This Court reviewed the Crown Delaware Opinion under the three prong test set forth in *United Parcel Service Inc. v. Comptroller,* 69 Md. App. (1986). As to the first prong, this Court holds that the Maryland Tax Court recognized and applied the correct principle of law governing the Crown Delaware case. Furthermore, as to the second prong, this Court examined the agency's factual findings to determine if they were supported by substantial evidence, i.e., by such relevant evidence as a reasonable mind might accept as adequate to support a conclusion. Where any inconsistent inferences that can be drawn, this Court gave deference to the agency's inferences, as required by *United Parcel Service Inc. v. Comptroller,* 69 Md. App. 458 (1986). This Court holds that

the Maryland Tax Court's factual findings were supported by substantial evidence in the Crown Delaware case in reference to the Regulation Promulgation issue.

Finally, the third prong requires this reviewing Court to examine how the agency applied the law to the facts on the nexus issue.

> This, of course, is a judgmental process involving a mixed question of law and fact, and great deference must be accorded to the agency. The test of appellate review of this function is 'whether . . . a reasoning mind could reasonably have reached the conclusion reached by the [agency] consistent with a proper application of the [controlling legal principles].

*United Parcel Service Inc.,* 69 Md. App. 458 (1986).

This Court has given the Maryland Tax Court great deference and holds that a reasoning mind could reasonably have reached the conclusion reached by the Maryland Tax Court in the Crown Delaware case in that there was a substantially new or change in policy and Comptroller's retroactive application of the Comptroller's policy was unacceptable and improper.

**III. Apportionment.**

The Maryland Tax Court relies on *MCIIT, Inc., supra,* to provide guidance in regard to the apportionment issue.

Having found that the requisite nexus to warrant

> the imposition of income tax on [MCIIT] does not exist, the issue of which apportionment factor is appropriate becomes moot. As an entity of substance with no nexus to Maryland, there is no Maryland income to calculate.
>
> Even if there were ties to Maryland, with an entity of substance rather than a phantom, the proper apportionment formula would utilize the sales, property and payroll of [MCIIT] itself. Only if [MCIIT] were a phantom would the principle of *Armco* and *Atlantic Supply* be applicable. In those cases, the Courts allowed the Respondent to employ the factor of the taxpayer's in-state parent and apply it to the phantom's income. With the present facts, i.e. no phantom, there is no authority for the use of the in-state affiliate's factors.

*MCIIT, Inc., supra,* p. 12.

While the Maryland Tax Court agrees with the Comptroller that the appropriate formula is that of applying its own factors, the Tax Court was not, as is this Court, convinced that the traditional apportionment formula results in a distorted enough income figure for Crown Delaware to warrant the three-factor formula proposed by its witness.

**IV. Penalties and Interest**

Similar to the prior issues, having found that Crown Delaware has no tax liability, the issue of penalties and interest are moot. However, it is the position of this Court,

as well as the Maryland Tax Court, that Crown Delaware acted in good faith, complied with existing (and current) law and that, if liability for income tax had been found, no penalty should have been imposed. It is also the consistent position of the Maryland Tax Court that the ability to waive interest lies solely with the Comptroller and this Court agrees.

**Conclusion.**

Applying the standard of review as required, this Court will affirm the Maryland Tax Court's decision and finds that the assessments imposed on Crown Delaware by the Comptroller for all of the tax years should be reversed.

DATED: March 17, 2000

JUDGE JOSEPH H. KAPLAN
This Judge's signature appears
on the original document.

## APPENDIX E — MEMORANDUM OF GROUNDS FOR DECISION IN THE MARYLAND TAX COURT FILED APRIL 26, 1999 (AND RELATED DECISIONS)

**IN THE**
**MARYLAND TAX COURT**

No. C-97-0028-01

CROWN CORK & SEAL (DELAWARE) INC.

v.

COMPTROLLER OF THE TREASURY

**MEMORANDUM OF GROUNDS FOR DECISION**

Crown Cork & Seal (Delaware) Inc., (hereinafter "Petitioner"), appeals an assessment issued by the Comptroller of the Treasury (hereinafter "Respondent") for Maryland income tax for the tax years 1989 through 1993. At hearings, testimony was taken, documents presented, and post-trial memorandum were filed.

Petitioner is a wholly owned subsidiary of Crown, Cork & Seal Company, Inc. (hereinafter "Crown Parent"), a public corporation in the business of manufacturing and selling metal cans, crowns, and closures for bottles (plastic and glass), can filling machines and containers. Crown Parent owned and operated manufacturing plants in Maryland and timely filed Maryland corporate income tax returns for the years in question.

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Petitioner was formed in Delaware and Crown Parent contributed its trademarks and patents to Petitioner. The marks were licensed back to Crown Parent for an agreed-upon royalty fee. As a result of the licensing arrangement between the related entities, Crown Parent's Maryland income was reduced by the amount of the royalties paid to Petitioner. Respondent assessed Petitioner on the basis that it was a "phantom" corporation.

The facts and issues presented by this appeal are virtually identical to those addressed in *SYL, Inc. v. Comptroller,* M.T.C. No. C-96-0154-01 (1999) issued the same day as the present case. The decision in *SYL, Inc.* shall be incorporated by reference for the resolution of the legal issues presented.[1] In *SYL, Inc.,* the Court determined that the assessment of an out-of- state affiliate of a corporate group for income taxes is constitutionally proper only if there exists nexus between the activities of the out-of-state affiliate and Maryland. In addition, the Court concluded that the attribution of nexus to a foreign corporation, under Maryland case law, is limited to phantom entities (i.e. no substance).

Thus, the factual resolution for the Court is whether nexus exists between Petitioner and Maryland. In order to meet Commerce Clause nexus requirements, there must be a "substantial nexus" with the taxing state. *Complete Auto Transit v. Brady,* 430 U.S. 274 (1977). Petitioner does not own or lease property in Maryland. Petitioner has no employees, agents or offices in Maryland. Its income producing activity all occurs outside of Maryland. Crown

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1. A copy of *SYL, Inc.* is attached.

Parent is the only contact Petitioner has with Maryland and that contact is not sufficient to meet the substantial requirement.

Nexus attributed to an out-of-state entity was found to be proper by the Maryland Courts only when the entities were true phantom corporations.[2] The evidence presented clearly shows that Petitioner is not a phantom or sham corporation. Petitioner is a viable entity established for valid business purposes, including the protection of valuable intellectual property rights from hostile takeovers of the parent corporation. Petitioner maintained an office in Delaware, met all corporate formalities, had separate bank accounts and employees performing services pursuant to written employment agreements. In addition, Petitioner received royalty income from third parties (other than Crown Parent or an affiliate) during some of the years in controversy.

As a non-phantom entity with no nexus with Maryland, Petitioner is not subject to Maryland income tax. The Respondent's erroneous emphasis on the extent of corporate substance and on the South Carolina decision, *Geoffrey, Inc. v. South Carolina Tax Commission,* 313 S.C. 15 (1993) was addressed in *SYL, Inc.,* supra, and no further discussion is necessary.

The resolution of the remaining issues presented are again fully addressed in *SYL, Inc.,* supra and we adopt the reasoning therein. The Respondent failed to follow the proper

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2. The case law is fully analyzed in *SYL, Inc.* and *MCIIT v. Comptroller,* M.T.C. No. C-96-0028-01 (1999).

rulemaking requirements when it amended its policy towards taxing foreign entities similar to Petitioner. Even if liability had been found, the apportionment formula used by Respondent failed to recognize the corporate substance of Petitioner. Finally, if Petitioner was subject to the tax, no penalty should have been imposed.

**Conclusion.**

For the above reasons, we shall pass an Order reversing the assessments imposed on the Petitioner, Crown Cork & Seal (Delaware) Inc. for all of the tax years involved.

*Appendix E*

**IN THE**
**MARYLAND TAX COURT**

NO. C-96-0154-01

SYL, INC.

V.

COMPTROLLER OF THE TREASURY

**MEMORANDUM OF GROUNDS FOR DECISION**

SYL, Inc. (hereinafter "Petitioner"), appeals an assessment issued by the Comptroller of the Treasury (hereinafter "Respondent") for Maryland income tax for the tax years 1986 through 1993. Taxes assessed totaled $326,685 for the eight years, plus penalties and interest, for total assessments of $637,362. At hearings, testimony was taken, documents were presented, and subsequently, memorandum were filed.

Petitioner was formed in December, 1986 as a subsidiary of Syms, a corporation engaged in the retail of off-price men's, women's, and children's retail clothing with its principal place of business in New Jersey. Syms has retail operations in Maryland. Evidence indicates that Petitioner was formed to hold and manage intangible asset such as trademarks, service marks, and trade names of its parent, Syms. The intangible assets transferred to Petitioner produced certain benefits to the corporate family, among them being the reduction of Maryland income tax liability of its parent,

Syms. Petitioner and Syms executed a licensing agreement whereby the "marks", now owned by Petitioner, were licensed to Syms for a fee. This fee paid to Petitioner reduced the Maryland taxable income of Syms and increased income to Petitioner. However, Delaware law does not tax Petitioner's licensing income. Since Maryland law requires each entity of an affiliated group to file their tax returns separately, the money paid to Petitioner from Syms was never taxed by Maryland.

An audit by Respondent claimed a basis for finding that the licensing fees paid to Petitioner were taxable. An assessment was issued, which was affirmed by the Respondent's hearing officer.

**Issues Presented**

The central issue for this Court involves whether Maryland statute or case law permits the imposition of tax on the income of an out-of-state affiliate of a Maryland parent corporation. The issue is identical to that addressed in *MCIIT v. Comptroller,* Maryland Tax Court No. C-96-0028-01 (1999) and it is to that decision that most of our analysis will refer. The major difference between this case and *MCIIT* is that the entity involved here is a holding company, not an operating corporation.

Similar to *MCIIT,* Petitioner asserts that a sufficient nexus does not exist between itself and Maryland to subject Petitioner to Maryland income tax. Respondent relies on Maryland case law for support of its assessment. In addition, Petitioner claims that the imposition of tax on an out-of-

state holding corporation without the promulgation of a regulation or the enactment of legislation violates Maryland case law and the Administrative Procedures Act. Respondent argues that the assessment reflects current law, is not a change in policy and therefore, no regulation or legislation was required in order for the assessment to be issued.

In addition, Petitioner asserts that, even if subject to the tax, Respondent utilized the incorrect apportionment formula and that the Respondent should have waived penalty and interest.

**I. Nexus.**

The nexus arguments were fully addressed in *MCIIT,* supra. The parties presented the same statutory and case law as support of their positions as in the instant appeal. The *MCIIT* analysis provided:

> Maryland imposes a tax on the taxable income of a corporation defined as "its Maryland modified income as allocated to the State. . ." § 10-301 of the Tax-General Article of the Annotated Code of Maryland.[1] Maryland modified income of a corporation is its federal taxable income, adjusted by the Maryland additions and subtractions, § 10-304 through 10-308. The computation of the tax requires the corporation to allocate Maryland modified income "derived from or reasonably attributable to its trade or business in this State",

1. All future statutory references shall be of the Tax-General Article, unless otherwise noted. FN. 3. *MCIIT v. Comptroller,* supra.

§ 10-402(a). If the entity earns its income from in and out of the State, that income derived from instate business activities must be allocated to Maryland, § 10-402(a)(1) & (2). If the corporation is unitary, then a 3-factor apportionment formula is applied to its income in order to determine Maryland taxable income of that corporation, § 10-402(c). Under subsection (d) of § 10-402, the Respondent may alter the allocation and apportionment of a corporation's income "to reflect clearly the income allocable to Maryland". Each corporate member of an affiliated group, even if unitary, is required to file a separate tax return to the Respondent, § 10-811 . . .

The parties both agree that Petitioner is a part of a unitary group of entities. Accordingly, relying on precedent established in two Maryland Court decisions, *Comptroller of the Treasury v. Armco Export Sales Corp.*, 82 Md.App. 429 (1990) and *Comptroller of the Treasury v. Atlantic Supply Co.*, 294 Md. 213 (1982), the Respondent asserted nexus over Petitioner based on the in-state activity of an affiliate, MCIT. Respondent first determined that Petitioner lacked "substantial economic substance", labeling Petitioner as a "phantom" corporation. As such, Respondent determined that the cases cited permit the attribution of "nexus and apportionment factors of the company or companies actually engaging in any real activity to the phantom company", Notice of Final Determination (Petitioner's Exhibit # 63).

*Appendix E*

We disagree with the Respondent's nexus attribution to Petitioner based on the *Armco* and *Atlantic Supply* decisions. Fundamental in both Court decisions is the determination that the taxpaying entity was a shell or phantom corporation with no economic substance. In *Armco,* the Court was faced with a statutorily created business organization known as a Domestic International Sales Corporation or DISC. The Court characterized the DISC as a "phantom book entry corporation created under federal tax laws . . .". In expounding on the phantom nature of a DISC. the Court noted that the DISC performed "no activity . . . to earn the income" *Armco, supra,* at 431; that "none of the DISC's had any tangible assets or employees anywhere; and that the DISC "can only conduct its activity and do business through branches of its unitary affiliated parent", *supra* at 430,435. In addition, the Court concluded there was specific legislative intent to subject the DISC's to Maryland income taxation.

In *Atlantic Supply,* nexus was not an issue. The taxpayer was clearly doing business in Maryland. The Court's focus was the taxation of an affiliate created for the specific purpose of obtaining the favorable wholesale price from a major supplier, Coca-Cola, which its parent, Macke Company, as a retailer, could not acquire. Emphasis was placed on the fact that the employees of the out-of-state affiliates were

authorized to, and did, act in the name of the taxpayer outside of the state. In addition, the Court noted that the taxpayer's business "could not function without the funds supplied by Mackeparent and without the Macke branches as captive customers." *Atlantic Supply,* supra at 223. The court concluded then that the taxpayer could apportion its income among the states in which it did business.

It is clear to this Court that the above holdings are limited in their scope. The entities involved lacked *any* economic substance,[2] thus earning their "phantom" status. Respondent's attempt to impose that status on corporations with substance is not justified through *Armco* and *Atlantic Supply.* Indeed, in this technologically advanced era, it is not practical as well. It is conceivable that, for legitimate business purposes, a seemingly insignificant affiliate (i.e. one employee and/or one computer) can exist which generates substantial income yet have little or no expense. To attribute nexus solely on the basis that there is reliance on Maryland affiliates for some or all of that income expands the limited holdings of *Armco* and *Atlantic Supply* and ignores the reality that they are separate non-phantom entities

2. It is interesting to note that Respondent's hearing officer found that Petitioner had no "substantial" or "significant" economic substance. We find nothing in either statute or case law that imposes a "substantial" requirement and will not infer one here. FN. 4, *MCIIT v. Comptroller,* supra.

required to report their income separately. *MCIIT,* supra, pages 6-8.

Based on *MCIIT,* applying *Armco* and *Atlantic Supply* to the Petitioner is justified only if Petitioner is a "phantom" corporation. For the following reasons, we conclude that Petitioner is an entity of substance and not a "phantom".

In the instant case, the evidence clearly indicates that Petitioner is not just a book entry corporation. Petitioner maintains an office in Delaware. That office contains office furniture and corporate and financial records are kept there. Mail is received at the Delaware office location. It has its own bank account and has an employee. Legal counsel was retained by Petitioner for purposes of protecting its "marks". The requisites for corporate existence were met; i.e. the drafting of by-laws, the election of a board of directors and corporate officers, the holding of regular and annual meetings, the recording of corporate minutes, and the ratification of dividends.

Respondent claims that Petitioner "was little more than a corporate vehicle designed to reduce state income taxes", (Respondent's Memorandum, p. 40), and points to the minimal expenses, the one employee, the mere formality of the corporate existence of Petitioner, and the timing of inter-entity transactions as support that Petitioner was creating the "illusion of substance", (Resp's Memorandum, p. 31). In short, Respondent assessed on the basis that the Petitioner was a sham entity for the sole purpose to avoid Maryland taxes.

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Even if that were true, *Armco* and *Atlantic Supply* only apply to entities with no substance whatsoever. In addition, it is well settled that tax avoidance ( rather than tax evasion) is a legitimate business purpose. If Petitioner was legally created with a tax avoidance purpose, absent authority and in a separate return environment, the Respondent cannot tax it. However, the evidence presented leads to the conclusion that Petitioner was established for non-tax reasons, among them:

- To hold and manage intangible assets in a separate corporation;
- To protect the transferred intangibles from the claims of Syms' creditors and from liabilities of Syms;
- To incorporate in a favorable corporate jurisdiction;
- To avert hostile take-overs; and
- To protect and enhance the value of Syms' name and its borrowing and business acquisition ability.

These facts easily distinguish the Petitioner from the phantom taxpayers in *Armco* and *Atlantic Supply.* Nexus cannot be attributed to it for Maryland taxation purposes.

Similar to *MCIIT,* the issue then turns to whether nexus can be directly found in Petitioner's activities. The Court

finds the analysis provided in that case is applicable to the present facts:

> The limits on the taxing powers of a state are found in the Due Process and Commerce Clauses of the Constitution. The Supreme Court reviewed the requirements of both Clauses in *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992).
>
> In *Quill,* the Court reiterated that the "Due Process Clause 'requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax,' and that the 'income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State"', *supra* at p.307, *citations omitted.* Overruling prior holdings, the Court determined that the minimum contacts necessary to establish the jurisdiction to tax does not require actual physical presence in the state, but can be found "if a foreign corporation purposefully avails itself of the benefits of an economic market in the forum State", *supra* at p. 307.
>
> The Supreme Court's analysis of the Commerce Clause begins with the requirements as set forth in its decision in *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977). *Complete Auto* provides a four part test which must be satisfied in order for a tax to pass muster against a Commerce Clause challenge. A tax is

sustained so long as the tax: "1) is applied to an activity with a substantial nexus with the taxing State, 2) is fairly apportioned, 3) does not discriminate against interstate commerce, and 4) is fairly related to the services provided by the State", *Complete Auto* at p. 279. In discussing the first prong of the test, the Supreme Court held that the "substantial nexus requirement is not, like due process' 'minimum contacts' requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce. Accordingly . . . a corporation may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the "substantial nexus' with that State as required by the Commerce Clause", *Quill* at p. 313. The Court reaffirmed the "bright-line" test it established in *National Bellas Hess, Inc. v. Department of Revenue,* 386 U.S. 753 (1967), that a taxpayer must have a physical presence in the taxing state in order to satisfy the substantial nexus requirement of the Commerce Clause.

In addressing the stricter "substantial nexus" requirement, Petitioner argues that since it has no physical presence in Maryland, the attempt to tax its income is a Commerce Clause violation pursuant to *Quill.* Respondent contends that the *Quill* Court explicitly noted that the physical presence requirement applies to sales and use taxes only. Reliance is also placed on the *Armco* and *Atlantic Supply* decisions to support the

application of an apportioned income tax to a corporation without any physical presence in Maryland.

The Respondent is correct in that the tax the *Quill* Court analyzed was a sales/use tax. The Court did note that "concerning other types of taxes we have not adopted a similar bright-line, physical presence requirement", 504 U.S. at p. 316. However, the Supreme Court also refused to restrict the rule to only sales and use taxes. "Although we have not, in our review of other types of taxes, articulated the same physical presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule", *supra* at p. 314. This lack of clarity on the parameters of the physical presence test has led to differing interpretations among the States as to what the Commerce Clause requires in relation to income-based taxes.

Absent apparent explicit direction, we hesitate to expand the *Quill* physical presence requirement to taxes other than sales and use. In so doing however, we note that "substantial nexus" with the taxing state is still required in order to pass constitutional muster. In the rulings of *Armco* and *Atlantic Supply,* due to the nature of the corporate phantoms, with no substance and therefore no presence anywhere, the normal nexus rules were ignored and the Courts found that nexus could be

> attributed based on the in- state presence and activity of an affiliate. The Commerce Clause was satisfied through the substantial nexus (the production and export of goods) of the in- state unitary affiliate.[3]
>
> However, as stated above, the instant case does not present us with a phantom. Petitioner is an entity of substance with a presence somewhere and thus the normal nexus (versus nexus attribution) rules apply. The focus of the substantial nexus requirement is on the entity sought to be taxed, not its in- state affiliate. *MCIIT,* supra, p. 9-11.

Focusing solely on Petitioner, we find that its lack of in-state activity precludes the imposition of the tax. Petitioner is not doing business in Maryland. Its income producing activity all occurs outside of Maryland. Petitioner has no offices, employees, agents or property in Maryland. Its only Maryland contact is an affiliation with an entity with a Maryland presence. This affiliation is hardly enough to satisfy substantial nexus.

Respondent relies on *Armco* and *Atlantic Supply* as support for the application of nexus due to the presence of Syms in Maryland. That reliance has been shown above to be erroneous. Respondent then points to the decision of

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3. Although the term "substantial nexus" was not used by the *Armco* Court, the *Complete Auto* Commerce Clause requirements had been established for thirteen years prior to the Armco decision. FN. 7, *MCIIT v. Comptroller,* supra.

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*Geoffrey, Inc. v. South Carolina Tax Commission,* 313 S.C. 15 (1993) as precedent in the taxing of a Delaware holding company licensing trademarks and trade names to its parent in-state company. The *Geoffrey* Court concluded that the use of intangible property (the "marks") by the in-state affiliate was sufficient to pass the constitutional nexus requirements in order to tax the out-of-state entity.

For two reasons, we disagree with the Respondent's use of the *Geoffrey* decision. First, *Geoffrey* dealt with South Carolina law and its application and therefore is not precedent for Maryland application. Second, as indicated above, we differ in our conclusions as to whether the substantial nexus requirement of the Commerce Clause was met. *Geoffrey* focused on the use of the marks by the in-state affiliate of the unitary group in order to determine the nexus of the foreign corporation. We disagree that that activity constitutes "substantial" nexus.

In addition, the unitary relationship between entities does not automatically establish nexus on all of the corporate entities in the unitary group. As we stated in *MCIIT,* supra:

> The mere presence of an in-state affiliate of a unitary group does not confer nexus on a non-phantom out-of-state affiliate of the same group, *Chesapeake Industries, Inc. v. Comptroller,* 59 Md.App. 370 (1984). In the unitary taxation scheme, the foreign corporation's income and factors may be included in determining the tax liability of the in-state affiliate. However, without

nexus, the foreign corporation does not become subject to the taxing jurisdiction.

> The Respondent claims that the corporate structure present here allows for the diversion of income away from Maryland through the internal transactions of affiliated entities which have no overall impact on the income of the unitary group. While this may be true, all such transactions are not necessarily abusive and in any event, these are the consequences of requiring affiliated corporations to file and report income separately. The Maryland Courts have addressed the treatment of such transactions when dealing with phantom corporations. With non-phantom corporations, such as Petitioner, the nexus rules as reiterated in *Quill* must still be applied to each affiliate before the State can tax. *MCIIT,* supra, p. 11.

Accordingly, we find that the Respondent has failed to satisfy the substantial nexus requirement of the Commerce Clause and the imposition of income tax on Petitioner's income is unconstitutional.

**II. Regulation Promulgation Due to Change in Policy.**

Having found that the requisite nexus to warrant the imposition of income tax on Petitioner does not exist, the issue of whether a regulation had to promulgated becomes moot. However, due to the number of taxpayers involved

and the likelihood of judicial review, we shall address the issue.

This Court concludes that the Respondent's attempt to assert tax against non- nexus, non-phantom trademark protection companies as a result of their licensing of the use of their trademarks, trade names and service marks to entities which have a nexus with the State amounts to a substantially new or change in policy which can only be instituted through the rulemaking procedures pursuant to *CBS, Inc. v. Comptroller,* 319 Md. 687 (1990) and the Maryland Administrative Procedures Act, Md.Code Ann., State Gov't § § 10-101 through 10-139. In *CBS, Inc.*, the Maryland Court of Appeals held that a change in an agency's "policy of general application" which results in "materially modified or new standards" may be made by prospective rulemaking only, *CBS,* p. 699. The Administrative Procedures Act requires that a change or implementation of policy by a State agency must be promulgated by regulation and that regulation may only be promulgated prospectively.

Prior to 1995, companies such as Petitioner were not subject to the tax. Phantom companies like those found in *Armco* and *Atlantic Supply* were subject to tax. In his latest statement of policy, ADR No. 2, titled "Interstate Commerce Tax Act—Domestic and Foreign Corporation—Nexus Requirements -Apportionment of Net Income, published in 1989, Respondent set forth the parameters of taxing foreign corporations. Nothing in that release, any regulation or statute since 1989 suggests that a foreign corporation with substance, with no business location, representatives, or other activities

within the State of Maryland could be subject to income tax as a result of the licensing of the use of intangible "marks" to in-state entities.

Beginning in 1995, (subsequent to the issuance of the *Geoffrey* decision), Respondent began asserting deficiencies against foreign trademark protection companies based on the in-state activities of their affiliates. Rather than a reflection of current policy, these assessments against substantial entities represented a change from its own stated policy (the 1989 Release) and that affirmed in *Armco* and *Atlantic Supply.* That change "materially modified" existing jurisdiction to tax standards to the detriment of taxpayers which had relied on the Respondent's past pronouncements. No regulations were promulgated or legislation enacted to effect this change in policy and, pursuant to *CBS, Inc.*, any retroactive attempt to tax Petitioner is improper. Respondent apparently believed that a regulation was necessary to expand the *Armco* policy as evidenced by the attempt to promulgate regulations relating to payments made by a Maryland taxpayer for "marks" from a contractor to an out-of state affiliated entity.[4] That attempt was rejected by the legislature and a review of their comments demonstrated that the retroactive application of the Respondent's policy was unacceptable.

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4. 24 Md. Reg. 1294 (Aug. 29, 1997) and 24 Md. Reg. 1314 (Aug. 29, 1997). The Respondent also attempted to enact legislation (HB 682, General Assembly Regular Session, 1998) to specifically provide for the taxation of foreign holding companies, but the bill was withdrawn before being bought to a vote.

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**III. Apportionment.**

*MCIIT, Inc.*, supra, provides guidance in regards to the apportionment issue:

> Having found that the requisite nexus to warrant the imposition of income tax on Petitioner does not exist, the issue of which apportionment factor is appropriate becomes moot. As an entity of substance with no nexus to Maryland, there is no Maryland income to calculate.
>
> Even if there were ties to Maryland, with an entity of substance rather than a phantom, the proper apportionment formula would utilize the sales, property and payroll of Petitioner itself. Only if Petitioner were a phantom would the principles of *Armco* and *Atlantic Supply* be applicable. In those cases, the Courts allowed the Respondent to employ the factor of the taxpayer's in- state parent and apply it to the phantom's income. With the present facts, i.e. no phantom, there is no authority for the use of the in-state affiliate's factors. *MCIIT, Inc.*, supra, p. 12.

While agreeing with the Petitioner that the appropriate formula is that applying its own factors, we are not convinced that the traditional apportionment formula results in a distorted enough income figure for Petitioner to warrant the three-factor formula proposed by its witness.

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**IV. Penalties and Interest.**

Similar to the prior issues, having found that the Petitioner has no tax liability, the issue of penalties and interest are moot. However, it is the position of this Court that the Petitioner acted in good faith, complied with existing (and current) law and that, if liability for income tax had been found, no penalty should have been imposed. It is also the consistent position of this Court that the ability to waive interest lies solely with the Respondent.

**Conclusion.**

For the above reasons, we shall pass an Order reversing the assessments imposed on the Petitioner, SYL, Inc., by the Respondent for all of the tax years involved.

*Appendix E*

**IN THE**
**MARYLAND TAX COURT**

NO. C-96-0028-01

MCI INTERNATIONAL
TELECOMMUNICATIONS CORP.

V.

COMPTROLLER OF THE TREASURY

**MEMORANDUM OF GROUNDS FOR DECISION**

Petitioner, MCI International Telecommunications, Inc. (hereinafter "MCIIT" or "Petitioner"), appeals an assessment issued by the Comptroller of the Treasury (hereinafter "Respondent") for Maryland income tax for the tax years ended March 31, 1991 through March 31, 1993. Taxes assessed totaled $2,2765,518 for the three years, plus penalties and interest, for total assessments of $4,425,859. At hearings, testimony was taken, documents presented, and motions and memorandum were filed.

**The Parties**

Before any recitation of the facts as presented, an explanation of the parties and affiliations is necessary.[1] Petitioner, MCIIT, describes itself as a wholesaler of international telecommunications services. It is part of an

1. All stated facts pertain to the time period of the assessment, unless specified otherwise.

affiliated group of corporations collectively known as MCI. The parent of the affiliated group is MCI Communications Corporation ("MCIC"). MCIC has two subsidiaries, reflecting the two areas of business in telecommunications. MCI Telecommunications Corporation ("MCIT") is the domestic communications arm of MCIC. MCIT operates throughout the United States, including Maryland. This entity is a long distance telephone service provider for U.S. domestic customers, familiar to many through their advertising.

MCI International, Inc. ("MCII") is the international business arm of MCIC. Its business is the provision of international telecommunications to its affiliates and other customers. It is located in New York. MCII is the parent corporation of both Petitioner, MCIIT, which handles international voice communication and Western Union International, Inc., which provides mostly data transmissions.

Thus, in the family scheme, MCIIT, the assessed entity, can be labeled as the child corporation to MCII, the nephew corporation to MCIT and the grandchild entity to MCIC.[2] The Respondent has assessed both Petitioner and its uncle corporation, MCIT, for income taxes.

**Summary of Pertinent Facts**

MCIIT provides international voice service to its customers. Its existence was mandated by the need to have a single entity operating in an environment heavily regulated

2. The corporate structure, in its most simplistic form, is best provided by Petitioner's Exhibit 4.

by the federal government through the Federal Communications Commission (FCC). In addition, the separate international company was a completely different type of business than the domestic voice transmission business. Different expertise, equipment, customers and regulations applied to international communications.

Initially, before MCIIT could begin any voice service between countries, operating agreements had to be reached with each country it wished to provide service. These agreements were negotiated, reviewed and executed by its parent MCII. The domestic carrier, MCIT, had nothing to do with the preparation of these agreements. Once signed and filed, the international entities had access to the respective countries.

MCII, the parent, also assisted MCIIT in the gaining of access to the equipment necessary to complete an international telephone call; namely, undersea cables, interconnecting cables, computer systems to track minutes and calls and satellite facilities. The cable is owned by an consortium of international telecommunications companies due to the expense of maintaining such a facility. MCIIT pays MCII a management fee in exchange for its services.

An international telephone call completed by the Petitioner starts at a mainland point. If it is an inbound call (to the United States), the call typically originates with the customer of a foreign telephone company (referred to in testimony as a "PTT"). The foreign PTT carries the call over the afore-mentioned submerged ocean cable. The foreign PTT bill their customers in their countries and then pay MCIIT a

service fee. At the midpoint on the ocean cable, MCIIT picks up the call and transmits it to a cablehead where the ocean cable reaches the shoreline. MCIIT pays a service fee to its parent, MCII, for the capacity to carry calls on the cable. MCIIT then carries the call to a "gateway switch". This switch is owned by one of the domestic long-distance carriers ("LDC"), i.e. AT & T, Sprint, or MCIT. The gateway switch is not located in Maryland. MCIIT terminates the call at the gateway switch, where the LDC picks up the call and transmits it over its domestic long distance network to the local exchange carrier (i.e. Bell Atlantic), who transmits it to their ultimate destination. MCIIT pays the LDC a service fee for carrying the calls on its network.

An outbound call would operate in the reverse fashion. The LDC would send the call to its gateway switch, where MCIIT picks it up and transfers it to the ocean midpoint to the PTT, who would complete the call on the foreign side of the transaction. In this instance, the LDC would pay MCIIT a service fee for its service in completing the international call. MCIIT would pay the PTT a service fee for taking its call and completing it.

It is the treatment of the service and management fees paid and received by MCIIT that has generated this appeal. Petitioner, in 1991, reported for the first time in its Maryland income tax returns, no Maryland payroll expenses and nominal property ownership. When combined with the substantially increased revenue reported, the Respondent asserted grounds for an audit. At hearing before this Court, testimony established that payroll expenses were included in the management fee paid by MCIIT to MCII, its parent.

That fee also paid for other services MCII provided; i.e. negotiations, accounting, procurement, data processing, etc. The fee was determined through an allocation of expenses by MCII to its subsidiaries. There was no specific agreement between the entities in defining the exact amount of the fee. In 1991, the fee paid by MCIIT to MCII was $56 million dollars.

As for the property, repeatedly the testimony indicated that MCIIT owned no property in Maryland. The cables and satellites were owned by other entities to which MCIIT paid a rent, then capitalized to determine their value for tax purposes. The rental expense was a fixed allocated amount, not based on actual usage. No specific rental agreement between the entities were introduced. The gateway switch to which international calls were either picked up or handed off were owned by the domestic long distance carriers, MCIT being one of them. They were not rented by Petitioner. Petitioner paid those owners a fee based on actual usage of the facility. None of the gateway switches were located in Maryland.

The filing of the 1991 tax returns triggered an audit and an assessment by the Respondent against both MCIIT, the Petitioner, and its uncle MCIT. The Respondent determined that the Petitioner was not a substantial entity and its existence was based solely as a means by which the in-state affiliate, MCIT, could divert taxable income to an out-of-state entity through the payment of service fees paid to MCIIT for transmissions it handled. Since that entity has no property, payroll or sales in Maryland, the income generated by the service fees from the PTT's and the LDC's could not be apportioned to Maryland.

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Relying primarily on case law, the Respondent used the income reported on the Petitioner's tax returns, applied the apportionment formula as derived from information on the domestic long distance corporation's (MCIT) returns and issued assessments against MCIIT. MCIIT appealed those assessments and a hearing was held by the Respondent. The hearing officer who heard the appeal was also, it was later discovered, actively involved in the audit of the Petitioner. He subsequently affirmed the assessments and the Petitioner filed a timely appeal with this Court.

**Issues Presented**

**I. Nexus.**

The Respondent can assess a tax on the income of an out-of-state entity if that entity has nexus with the State of Maryland. Petitioner presents two challenges to Respondent's assumption that nexus exists with Maryland.

First, Petitioner contends that neither Maryland statutes or case law impose nexus in order for Respondent to subject it to Maryland Income tax. It claims that it does not conduct any trade or business in Maryland and therefore, pursuant to Maryland law, its income cannot be subject to tax.

Petitioner next asserts that the Respondent's attempt to tax its income violates the Due Process Clause and the Commerce Clause of the United States Constitution. Specifically, Petitioner contends that the "minimum contacts" necessary for an entity to meet Due Process nexus with a taxing state does not exist here. As for the Commerce Clause,

Petitioner argues that is involved with no activity having "substantial nexus" with the taxing state and that since it has no physical presence with Maryland, Respondent's assessment violates the principles stated by the U.S. Supreme Court in *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992).

**II. Apportionment.**

Even if this Court finds that sufficient nexus exists for the imposition of income tax. Petitioner argues that the law mandates that the proper apportionment formula to be used in determining the amount of tax liability should be either one using the sales, property and payroll of the Petitioner itself or of its parent, MCII.

Petitioner claims that the application by the Respondent of the "uncle" corporation factor formula amounts to a change in policy of general application, the implementation of which requires either statutory or regulatory action, based on the decision in *CBS, Inc. v. Comptroller,* 319 Md. 687 (1990). Petitioner asserts that the lack of regulatory procedures violates the Maryland Administrative Procedures Act. In addition, Petitioner argues that the use of MCIT's apportionment factor results in unconstitutional unfair apportionment, unrelated to Petitioner's activities in Maryland.

**III. Procedural Violations.**

Petitioner asserts that the hearing officer's active involvement in the original audit violates the Petitioner's Fifth Amendment due process rights as well as the principles

mandated by the Administrative Procedures Act. According to the Petitioner, the Respondent permitted pervasive influence by the hearing officer on the auditor of Petitioner's records and therefore, any proceeding before that hearing officer was constitutionally suspect. Petitioner seeks dismissal of the assessments on those grounds.

**Conclusions of Law**

**I. Nexus.**

Maryland imposes a tax on the taxable income of a corporation defined as "its Maryland modified income as allocated to the State . . ." § 10-301 of the Tax- General Article of the Annotated Code of Maryland.[3] Maryland modified income of a corporation is its federal taxable income, adjusted by the Maryland additions and subtractions, § 10-304 through 10-308. The computation of the tax requires the corporation to allocate Maryland modified income "derived from or reasonably attributable to its trade or business in this State", § 10-402(a). If the entity earns its income from in and out of the State, that income derived from instate business activities must be allocated to Maryland, § 10- 402(a)(1) & (2). If the corporation is unitary, then a 3-factor apportionment formula is applied to its income in order to determine Maryland taxable income of that corporation, § 10-402(c). Under subsection (d) of § 10-402, the Respondent may alter the allocation and apportionment of a corporation's income "to reflect clearly the income allocable to Maryland". Each corporate member of an

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affiliated group, even if unitary, is required to file a separate tax return to the Respondent, § 10-811.

Absent the fact that a unitary relationship exists between the Petitioner and MCIT, the assessment would not have been imposed upon Petitioner's income. If the Petitioner was not part of a unitary group, the evidence indicates that Petitioner does not conduct any trade or business in this State. Petitioner either picks up outbound calls from or drops off foreign inbound calls to the LDC outside of Maryland at the gateway switch, It is this transporting of voice transmissions that generates the Petitioner's income. Since all of its income producing activity occurs outside of Maryland, pursuant to § 10-402, that income is outside of Maryland's taxing jurisdiction. Despite the Respondent's attempt in his memorandum to label the entire MCI corporate group as being the Petitioner in this assessment, the statutes warrant the consideration of each separate affiliate when determining a Maryland presence.

The parties both agree that Petitioner is a part of a unitary group of entities. Accordingly, relying on precedent established in two Maryland Court decisions. *Comptroller of the Treasury v. Armco Export Sales Corp.*, 82 Md.App. 429 (1990) and *Comptroller of the Treasury v. Atlantic Supply Co.*, 294 Md. 213 (1982), the Respondent asserted nexus over Petitioner based on the instate activity of an affiliate, MCIT. Respondent first determined that Petitioner lacked "substantial economic substance", labeling Petitioner as a "phantom" corporation. As such, Respondent determined that the cases cited permit the attribution of "nexus and apportionment factors of the company or companies actually

engaging in any real activity to the phantom company", Notice of Final Determination (Petitioner's Exhibit # 63).

We disagree with the Respondent's nexus attribution to Petitioner based on the *Armco* and *Atlantic Supply* decisions. Fundamental in both Court decisions is the determination that the taxpaying entity was a shell or phantom corporation with no economic substance. In *Armco,* the Court was faced with a statutorily created business organization known as a Domestic International Sales Corporation or DISC. The Court characterized the DISC as a "phantom book entry corporation created under federal tax laws . . .". In expounding on the phantom nature of a DISC, the Court noted that the DISC performed "no activity to earn the income" *Armco, supra,* at 431; that "none of the DISC's had any tangible assets or employees anywhere; and that the DISC "can only conduct its activity and do business through branches of its unitary affiliated parent", *supra* at 430,435. In addition, the Court concluded there was specific legislative intent to subject the DISC's to Maryland income taxation.

In *Atlantic Supply,* nexus was not an issue. The taxpayer was clearly doing business in Maryland. The Court's focus was the taxation of an affiliate created for the specific purpose of obtaining the favorable wholesale price from a major supplier, Coca-Cola, which its parent, Macke Company, as a retailer, could not acquire. Emphasis was placed on the fact that the employees of the out-of-state affiliates were authorized to, and did, act in the name of the taxpayer outside of the state. In addition, the Court noted that the taxpayer's business "could not function without the funds supplied by Macke- parent and without the Macke branches as captive

customers." *Atlantic Supply,* supra at 223. The court concluded then that the taxpayer could apportion its income among the states in which it did business.

It is clear to this Court that the above holdings are limited in their scope. The entities involved lacked *any* economic substance,[4] thus earning their "phantom" status. Respondent's attempt to impose that status on corporations with substance is not justified through *Armco* and *Atlantic Supply.* Indeed, in this technologically advanced era, it is not practical as well. It is conceivable that, for legitimate business purposes, a seemingly insignificant affiliate (i.e. one employee and/or one computer) can exist which generates substantial income yet have little or no expense. To attribute nexus solely on the basis that there is reliance on Maryland affiliates for some or all of that income expands the limited holdings of *Armco* and *Atlantic Supply* and ignores the reality that they are separate non-phantom entities required to report their income separately.

In the instant case, Petitioner is not just a book entry corporation. The evidence clearly indicates that it performed activity (the transfer of inbound and outbound calls over international territory) that generated income. The revenues were earned from non-affiliated entities as well as MCIT. Petitioner has substantial property on its books and has incurred personnel expense through the payment of management fees to its parent, MCII. Unlike in *Armco,*

4. It is interesting to note that Respondent's hearing officer found that Petitioner had no "substantial" or "significant" economic substance. We find nothing in either statute or case law that imposes a "substantial" requirement and will not infer one here.

*Appendix E*

Petitioner's corporate officers, operating territory, property, and employees are different from those of the instate corporation, MCIT. Unlike *Atlantic Supply,* there was no evidence to indicate that MCIT employees were authorized to act in the name of Petitioner. The evidence indicated that Petitioner was not solely dependent on MCIT and that it could function as a stand-alone corporation and do business with the other LDC's. MCIT was not a captive customer of Petitioner.

Finally, unlike the specific provision enacted by the legislature regarding DISC's, the taxation of foreign corporations based on the transactions between them and their in-state affiliate has not been adopted by either statute or regulation. The rejection by a legislative committee of proposed regulations[5] and the subsequent introduction of legislation[6] to specifically provide for that taxation supports Petitioner's argument that legislative intent was lacking.

In short, contrary to the DISC in *Armco* and the in-state affiliate in *Atlantic Supply.* Petitioner is not a phantom corporation and therefore, nexus cannot be attributed to it for Maryland taxation purposes.

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5. 24 Md. Reg. 1294 (Aug. 29, 1997) and 24 Md. Reg. 1314 (Aug. 29, 1997)

6. House Bill 682, General Assembly Regular Session 1998. The bill was withdrawn before being brought to a vote. Although this bill was presented subsequent to the hearing in the instant case, it is relevant to the issues involved.

Having found no support for attributing nexus, the question then is whether the United States Constitution permits the imposition of nexus directly on the foreign affiliate. The limits on the taxing powers of a state are found in the Due Process and Commerce Clauses of the Constitution. The Supreme Court reviewed the requirements of both Clauses in *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992).

In *Quill,* the Court reiterated that the "Due Process Clause 'requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax,' and that the 'income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State'", *supra* at p. 307, *citations omitted.* Overruling prior holdings, the Court determined that the minimum contacts necessary to establish the jurisdiction to tax does not require actual physical presence in the state, but can be found "if a foreign corporation purposefully avails itself of the benefits of an economic market in the forum State", *supra* at p. 307.

The Supreme Court's analysis of the Commerce Clause begins with the requirements as set forth in its decision in *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977). *Complete Auto* provides a four part test which must be satisfied in order for a tax to pass muster against a Commerce Clause challenge. A tax is sustained so long as the tax: "1) is applied to an activity with a substantial nexus with the taxing State, 2) is fairly apportioned, 3) does not discriminate against interstate commerce, and 4) is fairly related to the services provided by the State", *Complete Auto* at p. 279. In discussing

the first prong of the test, the Supreme Court held that the "substantial nexus requirement is not, like due process' 'minimum contacts' requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce. Accordingly . . . a corporation may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the "substantial nexus' with that State as required by the Commerce Clause", *Quill* at p. 313. The Court reaffirmed the "bright-line" test it established in *National Bellas Hess, Inc. v. Department of Revenue,* 386 U.S. 753 (1967), that a taxpayer must have a physical presence in the taxing state in order to satisfy the substantial nexus requirement of the Commerce Clause.

In addressing the stricter "substantial nexus" requirement, Petitioner argues that since it has no physical presence in Maryland, the attempt to tax its income is a Commerce Clause violation pursuant to *Quill.* Respondent contends that the *Quill* Court explicitly noted that the physical presence requirement applies to sales and use taxes only. Reliance is also placed on the *Armco* and *Atlantic Supply* decisions to support the application of an apportioned income tax to a corporation without any physical presence in Maryland.

The Respondent is correct in that the tax the *Quill* Court analyzed was a sales/use tax. The Court did note that "concerning other types of taxes we have not adopted a similar bright-line, physical presence requirement", 504 U.S. at p. 316. However, the Supreme Court also refused to restrict the rule to only sales and use taxes. "Although we have not, in our review of other types of taxes, articulated the same

physical presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule", *supra* at p. 314. This lack of clarity on the parameters of the physical presence test has led to differing interpretations among the States as to what the Commerce Clause requires in relation to income-based taxes.

Absent apparent explicit direction, we hesitate to expand the *Quill* physical presence requirement to taxes other than sales and use. In so doing however, we note that "substantial nexus" with the taxing state is still required in order to pass constitutional muster. In the rulings of *Armco* and *Atlantic Supply,* due to the nature of the corporate phantoms, with no substance and therefore no presence anywhere, the normal nexus rules were ignored and the Courts found that nexus could be attributed based on the in- state presence and activity of an affiliate. The Commerce Clause was satisfied through the substantial nexus (the production and export of goods) of the instate unitary affiliate.[7]

However, as stated above, the instant case does not present us with a phantom. Petitioner is an entity of substance with a presence somewhere and thus the normal nexus (versus nexus attribution) rules apply. The focus of the substantial nexus requirement is on the entity sought to be taxed, not its in-state affiliate.

Initially, we determined that if Petitioner were a non-unitary corporation, its lack of in-state activity would

7. Although the term "substantial nexus" was not used by the *Armco* Court, the *Complete Auto* Commerce Clause requirements had been established for thirteen years prior to the Armco decision.

preclude the imposition of the tax. Its income producing activity all occurs outside of Maryland. Petitioner has no offices, employees, agents or property in Maryland. Its only Maryland contact is an affiliation with an entity with a Maryland presence. This affiliation is hardly enough to satisfy substantial nexus.

The fact that Petitioner is part of a unitary group does not alter the above facts nor magically increase its Maryland presence in order to meet Commerce Clause criteria for nexus. The mere presence of an in-state affiliate of a unitary group does not confer nexus on a non-phantom out-of-state affiliate of the same group, *Chesapeake Industries, Inc. v. Comptroller,* 59 Md.App. 370 (1984). In the unitary taxation scheme, the foreign corporation's income and factors may be included in determining the tax liability of the in-state affiliate. However, without nexus, the foreign corporation does not become subject to the taxing jurisdiction.

The Respondent claims that the corporate structure present here allows for the diversion of income away from Maryland through the internal transactions of affiliated entities which have no overall impact on the income of the unitary group. While this may be true, all such transactions are not necessarily abusive and in any event, these are the consequences of requiring affiliated corporations to file and report income separately. The Maryland Courts have addressed the treatment of such transactions when dealing with phantom corporations. With non-phantom corporations, such as Petitioner, the nexus rules as reiterated in *Quill* must still be applied to each affiliate before the State can tax.

Accordingly, we find that the Respondent has failed to satisfy the substantial nexus requirement of the Commerce Clause and the imposition of income tax on Petitioner's income is unconstitutional.[8]

**II. Apportionment.**

Having found that the requisite nexus to warrant the imposition of income tax on Petitioner does not exist, the issue of which apportionment factor is appropriate becomes moot. As an entity of substance with no nexus to Maryland, there is no Maryland income to calculate.

Even if there were ties to Maryland, with an entity of substance rather than a phantom, the proper apportionment formula would utilize the sales, property and payroll of Petitioner itself. Only if Petitioner were a phantom would the principles of *Armco* and *Atlantic Supply* be applicable. In those cases, the Courts allowed the Respondent to employ the factor of the taxpayer's in-state parent and apply it to the phantom's income. With the present facts, i.e. no phantom, there is no authority for the use of the in-state affiliate's factors.

Finally, in anticipation of judicial review, we agree with the Petitioner in its argument that the Respondent's attempt to deviate from the traditional three-factor formula in the case of a entity of substance or its use of the factor of an "uncle" affiliate in the case of a phantom corporation violates the ruling in *CBS, Inc. v. Comptroller,* 319 Md. 687 (1990)

8. In light of our Commerce Clause ruling, it is unnecessary to address the Due Process issue presented by the Petitioner.

and the Maryland Administrative Procedure Act, Md.Code Ann., State Gov't §§ 10-101 through 10-139. In *CBS,* the Maryland Court of Appeals held that a change in an agency's "policy of general application" which results in "materially modified or new standards" may be made by prospective rulemaking only, *CBS,* p. 699. The APA requires that a change or implementation of policy by a State agency must be promulgated by regulation and that regulation may only be promulgated prospectively.

Rather than a reflection of current policy, the Respondent's apportionment formula of Petitioner represented a change from its own stated policy[9] and that affirmed in *Armco* and *Atlantic Supply.* That change "materially modified" existing apportionment standards to the detriment of taxpayers which had relied on the Respondent's past pronouncements. No regulations were promulgated or legislation enacted to effect this change in policy. Further evidence that this was a change can be found by virtue of the Respondent's attempt to promulgate procurement regulations relating to payments made by a Maryland taxpayer for trademarks, tradenames or intangible property from a contractor to an out-of-state affiliated entity.[10] Although these Regulations deal with holding company situations and, therefore, are not directly on point with the present situation, they indicate that the Respondent determined that its expansion of *Armco* from applying only to DISC's was a change in policy that required the adoption of regulations. A review of the legislature's comments

9. Corporate Income Administrative Release No. 2 (Petitioner's Exhibit No. 84)

10. See Footnote n. 5.

explaining their subsequent rejection demonstrated that the retroactive application of the Respondent's policy was unacceptable.

**III. Procedural Violation.**

Similar to the apportionment issue, having found that the Petitioner has no tax liability, the issue of the behavior of the hearing officer in the audit process becomes moot. However, the unusual[11] situation presented warrants review.

Testimony, documents and deposition testimony establish that the audit of the Petitioner was initiated, guided and signed off on by the hearing officer designated by the Respondent to hold the informal hearing mandated by § 13-508 of the Tax-General Article. Not surprisingly, the result of the hearing was not favorable to the Petitioner. Upon learning of the hearing officer's involvement, Petitioner filed a Motion to Dismiss the Assessment on the first day of the hearing before this Court to which Respondent filed a response.[12]

The substance of Petitioner's Motion is that the hearing officer's involvement in the audit violates both the Due

11. This issue is one of first impression with this Court.

12. Respondent insisted that a hearing on this Motion was necessary to allow him the opportunity to offer evidentiary support for his position. However, a hearing on any Motion is within the sole discretion of the Court. Respondent was repeatedly advised that evidence could be submitted during the presentation of his case in chief (submission of which was not onerous considering the time lapse between the days of hearing).

Process Clause and the Administrative Procedures Act's right to a fair trial. Petitioner seeks dismissal contending that anything less would "in effect, condone the conduct of the audit . . . sanctioning the processes whereby hearing officer and auditor could engage in a secretive and undisclosed collaboration that effectively reduces the appeal process to a nullity" and make "a mockery of all administrative proceedings before the Comptroller." Petitioner's Memorandum in Support of Motion to Dismiss or Abate Assessment, p. 15.

Respondent argues that its procedures and hearings are not subject to due process and APA requirements. In the alternative, the Respondent disputes that dismissal is the proper remedy.

The case law and arguments Petitioner presents do not convince us that due process and APA independent review is required at the "informal" hearing established in § 13-508. A similar informal process exists in the property tax area, where the initial review of an assessment is before the assessor who made the value determination. While Respondent's conduct, in terms of the appearance of fairness, may be improper and raises questions, there is no statutory prohibition and it does not merit the constitutional sanctions that Petitioner seeks.

**Conclusion**

For the above reasons, we shall pass an Order reversing the assessments imposed on the Petitioner, MCIIT, by the Respondent for all of the tax years involved.

**APPENDIX F — NOTICE OF FINAL DETERMINATION OF THE COMPTROLLER OF THE TREASURY, COMPLIANCE DIVISION DATED FEBRUARY 25, 1997**

**COMPTROLLER OF THE TREASURY**

**NOTICE OF FINAL DETERMINATION**

**COMPLIANCE DIVISION**
301 WEST PRESTON STREET
BALTIMORE, MARYLAND 21201-2383

Mr. Frank Dwyer
Crown Cork & Seal Co., Inc.
9300 Ashton Road
Philadelphia, PA 19136

Re: Crown Cork & Seal Co., (Delaware) Inc.

*FINAL AMOUNTS DUE*:

| | **1989** | **1990** | **1991** | **1992** | **1993** |
|---|---|---|---|---|---|
| Corporate Income Tax | $ 88,628. | $178,568. | $190,033. | $163,966. | $138,066. |
| Int. Accrued to Date | $ 78,405. | $135,119. | $120,940. | $ 84,386. | $ 53,107. |
| Penalty | $ 22,157. | $ 44,641. | $ 47,508. | $ 40,992. | $ 34,516. |
| TOTAL | $189,190. | $358,328. | $358,481. | $289,346. | $225,689. |
| GRAND TOTAL | | | | | **$1,421,034.** |

*Appendix F*

This is the Comptroller's final determination on your request for revision of the above assessment, pursuant to Tax-General Article Section 13-508(c).

*Background*

Crown, Cork & Seal Co., (Delaware) Inc. ("CCSDE") was assessed Maryland corporate income tax on July 11, 1996. In general, the Comptroller's office assessed CCSDE, a tax-haven entity earning substantial related party income, based on the position that CCSDE was a phantom entity that did not have substantial economic substance. The Comptroller's audit section concluded that CCSDE's lack of substantial substance and its dependence on Crown, Cork & Seal Co., Inc. ("Crown") for its earnings required CCSDE to file returns with Maryland based on the apportionment factor of its parent company Crown. The Comptroller's audit section relied upon *Comptroller v. Armco,* 572 A.2d 562 (1980) (cert. denied) and *Comptroller v. Atlantic Supply Co.,* 448 A.2d 955 (1982). The Comptroller's Office believes these decisions are consistent with Tax-General Article. Section 10-402 which generally requires that the income reasonably and fairly attributable to carrying on business in Maryland be taxable by Maryland. In short, the Comptroller's audit section found CCSDE to be a phantom or bookkeeping entity and taxed it based on economic reality and the true source of its income.

*Findings*

In April 1989, Crown incorporated CCSDE in Delaware and putatively assigned to CCSDE its ownership in patents

and trademarks. As part of an overall plan, CCSDE licensed back to Crown the patents and trademarks generally based on a royalty of 3% of net sales. This arrangement provided Crown with significant state income tax savings because (a) Crown deducted the royalty payments to CCSDE: (b) CCSDE immediately "leaned" the full royalty payments back to Crown charging interest which Crown was able to deduct and (c) CCSDE did not report its royalty and interest income as taxable in Maryland or other separate return states other than Delaware. Since Delaware does not generally tax in from intangibles, CCSDE generated substantial state income tax benefits.

Trademark law is an important consideration in determining whether a tax-haven entity such as CCSDE is a phantom or bookkeeping entity which merely appears to have substantial economic substance.

(a) Trademarks generally do not exist separate from goodwill and an assignment to mark without goodwill is a naked (invalid) assignment. *Haymaker Sports, Inc. v. Turian,* 581 F.2d 257 (1978), *Visa, USA Inc. v. Birmingham Trust National Bank,* 696 F.2d 1371 (1982).

(b) A mark must be used in order not to be abandoned. *Turner v. HMH,* 380 F.2d 224 (1967); 15 USCS Sections 1051, 1055. The use of a mark may be attributed to a related company but the related company must control the use of the mark in both nature and quality. Quality control must be affirmatively exercised and requires reasonable policing by the licensor to assure on-going quality of the goods or services to which mark is connected. *Huntington National Mattress*

*Co. v. Celonese Corp.*, 201 F.Supp 938 (1962); *Dawn Donut Company v. Hart's Food Stores, Inc.*, 267 F.2d 358 (1959).

A leading expert in trademark law has noted that it is generally inadvisable subsidiaries nominally own trademarks. McCarthy, J. Thomas, *McCarthy on Trademarks and Unfair Competition,* at 16-45. The treatise states,

> As a matter of practice, it generally is preferable to treat the parent as "owner" of all marks used by subsidiary corporations, since this structure avoids several possible complications. Justice Brennan, speaking for he majority of the Supreme Court on the point, quoted this treatise and observed that "the parent corporation — not the subsidiary whose every decision it controls — better fits the bill as the true owner of any [trademark] property that the subsidiary nominally possesses." *K Mart Corp. v. Cartier, Inc.*, 486 U.S. 281, 100 L. Ed. 2d 313, 108 S. Ct. 1811, 6 USPQ2d 1857 (1988).

This hearing officer has little difficulty concluding the CCSDE had little, if any economic substance and was clearly dependent on its affiliate, Crown, for its earnings. CCSDE's income was clearly generated by Crown's goodwill. Crown's use of the marks and Crown's other activities. CCSDE's existence was merely apparent — not real — and its taxation in Maryland is based on reality.

*Appendix F*

While by no means exhaustive, I find some of the salient and controlling facts as follows:

1) CCSDE was a thinly constituted entity with very little, if any, true economic operational activity in that:

(a) It paid out very little wages (from a low of $148.00 in 1989 to high of $843.66 in 1993), and the wages it did pay were paid to employees of a third party "nexus service provider" which was in the business of providing tax-haven entities with "apparent substance." CCSDE contracted with this "nexus service provider" which provides mail forwarding, shared office space and shared employees for numerous other tax-haven entities. See attached promotional materials of OSI. The president of this company, Organization Service, Inc. ("OSI") (who was also the secretary of CCSDE), indicated that he and his firm provided this same service to approximately 400 other entities. The nine employees of OSI worked an aggregate of 3.2 to 37.5 hours per year over the audit permit on behalf of CCSDE.

(b) CCSDE had no separate office or employees other than the shared space and employees of OSI and officers of Crown who also served as officers and directors of CCSDE but were compensated solely by Crown. CCSDE paid yearly rent of $960.00 to $1,200.00 per year for their office space which was nothing more than a conference room, located in OSI's office, which was "shared" with OSI's 400 or so other clients. On a visit to the tax-haven's purported office site, the Comptroller's auditor found that building security had never heard of Crown Cork & Seal.

(c) Royalties paid to CCSDE were contemporaneously returned to Crown as "loans". This circular flow demonstrates a mere "booking" of income by CCSDE as a phantom entity.

(d) CCSDE had no separate phone listing, phone service or office signage. The phone number used by CCSDE was a universal number for all of OSI's clients.

(e) Though requested, CCSDE could not produce travel expense reports showing business activity.

(f) CCSDE officers and employees did not have business cards, job descriptions, job evaluations or other indicia of a true employment relationship.

2) While goodwill existed on the books of Crown, none apparently existed on CCSDE's books. Since goodwill is inextricicably tied to customer patronage and since no customers had dealings with the tax-haven, it is evident that CCSDE had absolutely no goodwill of its own. Thus, the marks were either nakedly assigned and ineffective or effective only because trademark law attributes the goodwill to CCSDE. Either conclusion supports the view that CCSDE was a phantom company which was compensated for something which did not have value or whose value lied with Crown's goodwill and customers.

3) CCSDE did not use the marks and patents. CCSDE did not participate in, or oversee, manufacturing or sales activities. CCSDE did not control and as a thinly constituted subsidiary, did not factually or legally have the capacity to

control the use of marks and patents by a parent company, Crown, which owned it. Control was a factual and legal impossibility.

4) CCSDE had no direct and meaningful involvement in the control, marketing, protection and administration of the marks and patents. In fact, the license agreements explicitly state that the licensee, Crown, was the party responsible for the marks and patents. Any quality control that was carried out (although none was shown to have been done) was done by Crown. At the hearing, George Warren, Secretary of CCSDE and President of OSI, testified that to his knowledge, any quality control work would have been carried out by Crown. He stated that his responsibility was in strictly keeping "custody of intangibles". He said this involved keeping four documents (assignment and license agreement for both the patents and the marks) in a safe deposit box at a bank. All activity with regards to the marks and patents remained with Crown.

In summary, it is obvious that Crown took certain minimal steps to give CCSDE the appearance of substance. Unlike in *Armco*, where the phantom DISC profits were authorized by federal law, no authority sanctions the use of tax-haven entities to artificially shift income into thinly constituted phantom entities.

Additionally, there is even trademark law support for the proposition that the exclusive and indefinite license back of the marks to Crown should be considered an assignment back to Crown of the marks. Thus, under trademark law it is quite possible that Crown remained the substantive owner

of the mark. Whether such is the case (which clearly warrants further legal review) or whether CCSDE owned the marks in name only, it is plainly evident that CCSDE existed on books and paper only as a desk drawer entity nominally owning marks.

From a legal standpoint, it is difficult to find fault in the Comptroller's assessment. As in *Armco,* the Comptroller's Office appropriately determined how CCSDE's income should be taxed. Since CCSDE was found to be a phantom, it was clearly appropriate to look to the true underlying source of its income. CCSDE's booked income was in reality generated from Crown's manufacturing and sales activities.

It was Crown's use of the marks, its goodwill and its efforts in Maryland and elsewhere which gave the marks value and generated the income which was merely "booked" in CCSDE.

The assessment is wholly consistent with the long-standing treatment of phantom companies in Maryland. The Comptroller's assessment applied well-established law to facts which Crown and other taxpayers deploying tax-haven entities have not sought rulings upon and perhaps have been, quite understandably, reluctant to share. At least one nexus service provider has suggested that the use of a typical "desk drawer" type entity such as that deployed by CCSDE might be aggressive and imprudent.

No factual legal basis exists for abating penalty. CCSDE was wholly bereft of any meaningful substance. Therefore, penalty is affirmed in full.

Finally, given the relative merits of CCSDE's position in this case, it is simply not necessary to address herein any other alternative basis for concluding that the tax-haven entity should have been properly filing in Maryland. It is sufficient to note that Maryland applies its nexus laws to the full extent permitted by federal and constitutional law.

If you are dissatisfied with this final determination, AN APPEAL MUST BE TIMELY FILED IN THE MARYLAND TAX COURT within 30 days of the data shown above. DO NOT FILE AN APPEAL WITH THE COMPTROLLER OF THE TREASURY. If you do not appeal in accordance with procedures of the Maryland Tax Court within 30 days, this final determination will been an absolute liability which must be promptly paid, and the payment may not be refunded for any reason. Appropriate forms for use in filing appeals may be obtained from the MARYLAND TAX COURT at 301 West Preston Street, Suite 1513, Baltimore, Maryland 21201, telephone number (410) 767-4830.

s/ Charles A. Hall
Charles A. Hall, Esq.
Hearing Officer
(410) 767-1572

## APPENDIX G — RELEVANT STATUTES

### STATE-LAW, MD-TAXRPTR-99 ¶94-891, SEC. 10-402. SAME—FOR CORPORATION

**Sec. 10-402. Same—For corporation.—**

(a) *In general.*—In computing Maryland taxable income, a corporation shall allocate Maryland modified income derived from or reasonably attributable to its trade or business in this State in the following manner:

(1) if a corporation carries on its trade or business wholly within the State, the corporation shall allocate to the State all of the Maryland modified income of the corporation; and

(2) if a corporation carries on its trade or business in and out of the State, the corporation shall allocate to the State the part of the corporation's Maryland modified income that is derived from or reasonably attributable to the part of its trade or business carried on in the State, in the manner required in subsection (b), (c), or (d) of this section.

(As amended by Ch. 5, Laws 1989, effective March 9, 1989.)

(b) *Determination—By separate accounting.*—(I) Except as provided in subsection (c) or (d) of this section, the part of the corporation's Maryland modified income derived from or reasonably attributable to trade or business carried on in the State may be determined by separate accounting if practicable.

(2) If in any taxable year a corporation is permitted or required to use the separate accounting method in determining all or a portion of its Maryland taxable income, the portion that is separately accounted for to Maryland shall be taxable whether or not the Maryland modified income of the corporation for the taxable year is zero or less.

(As amended by Ch. 171, Laws 1989, effective June 1, 1989, applicable to all taxable years beginning after December 31, 1988.)

(c) *Same—By 3-factor apportionment formula.*— (1) If the trade or business is a unitary business, the part of the corporation's Maryland modified income derived from or reasonably attributable to trade or business carried on in the State shall be determined using a 3-factor apportionment fraction:

(i) the numerator of which is the sum of the property factor, the payroll factor, and twice the sales factor; and

(ii) the denominator of which is 4.

(2) The property factor under paragraph (1) of this subsection shall include:

(i) rented and owned real property; and

(ii) tangible personal property located in the State and used in the trade or business.

(As amended by Ch. 1, Laws 1992, 1st Sp. Sess., effective May 1, 1992; Ch. 249, Laws 1992, effective July 1, 1992, applicable to taxable years beginning on or after December 31, 1991.)

*Appendix G*

(d) *Same—By Comptroller.*—To reflect clearly the income allocable to Maryland, the Comptroller may alter, if circumstances warrant, the methods under subsections (b) and (c) of this section, including:

(1) the use of the separate accounting method;

(2) the use of the 3-factor double weighted sales factor formula method;

(3) the weight of any factor in the 3-factor formula;

(4) the valuation of rented property included in the property factor; and

(5) the determination of the extent to which tangible personal property is located in the State.

(As amended by Ch. 1, Laws 1992, I st Sp. Sess., effective May 1, 1992; Ch. 249, Laws 1992, effective July 1, 1992, applicable to taxable years beginning on or after December 31, 1991.)

*Appendix G*

## STATE-LAW, MD-TAXRPTR-99 ¶94-954, SEC. 10-811. SAME—AFFILIATED CORPORATIONS.

**Sec. 10-811. Same—Affiliated corporations.—**

Each member of an affiliated group of corporations shall file a separate income tax return.

## STATE-LAW, MD-TAXRPTR-99 ¶95-399, SEC. 13-523. CONDUCT OF PROCEEDINGS.

**Sec. 13-523. Conduct of proceedings.—**

An appeal before the Tax Court shall be heard de novo and conducted in a manner similar to a proceeding in a court of general jurisdiction sitting without a jury.

## APPENDIX H — PETITION OF APPEAL DATED MARCH 20, 1997

## IN THE MARYLAND TAX COURT

_____ Docket
Case No. C-97-0028-01

CROWN CORK & SEAL COMPANY
(DELAWARE) INC.
103 Springer Building
3411 Silverside Road
Wilmington, Delaware 19810

Petitioner,

v.

COMPTROLLER OF THE TREASURY

Respondent.

### PETITION OF APPEAL

The Petitioner, Crown Cork & Seal Company (Delaware) Inc. (the "Petitioner"), by its attorneys, Robert J. Carson, Daryl J. Sidle, and Smith, Somerville & Case, L.L.C., represents unto this Honorable Court as follows:

1. That this is an appeal from an assessment of corporate income tax, interest and penalty against the Petitioner covering the Petitioner's 1989, 1990, 1991, 1992 and 1993 tax years, made pursuant to Tax-General Article Section 13-518(c) of the Annotated Code of Maryland.

2. That the agency whose action the Petitioner complains of is the Comptroller of the Treasury, Income Tax Division.

3. That the total amount of the assessment is $759,263.00 in tax, plus $471, 957. 00 in interest to the date of the Notice of Final Determination, and $189,814.00 in penalty, all as set forth in a Notice of Final Determination of the Hearing officer, dated February 24, 1997, a copy of which is attached hereto as Exhibit A.

4. That the date of the action complained of is February 25, 1997.

5. The facts upon which Petitioner relies are as follows:

(a) The Petitioner, a Delaware based corporation, was organized in April, 1989, by its parent corporation, Crown, Cork & Seal Company, Inc. ("Crown"), to hold certain intellectual property rights consisting of patents, inventions and trademarks in the name of a separate entity.

(b) At all relevant times, the Petitioner has been a viable and autonomous corporation having as a valid business purpose the protection, maintenance and management of these valuable intangible assets. Holding these intellectual property rights in a separate corporation served the additional business purposes of: (i) insulating these assets from the claims of Crown's creditors; (ii) facilitating the licensing of the Crown name to third parties; and (iii) enhancing the ability to borrow through a debt free subsidiary.

(c) Crown transferred the intellectual property rights to the Petitioner in a transaction exempt from Federal and Maryland income tax pursuant to Section 351 of the Internal Revenue Code. Petitioner received royalties, at a rate established through an independent appraisal conducted by American Appraisal Associates, for the use of the intellectual property rights pursuant to a License Agreement, dated June 13, 1989, and a Patent License Agreement, dated June 13, 1989.

(d) Upon organization, the Petitioner employed the services of Organization Service, Inc. ("OSI") to facilitate the establishment of its business operations. In July, 1989, the Petitioner entered into an agreement to lease office space from OSI, and hired employees of OSI to manage the Petitioner's daily operations. Each of these employees had written employment agreements with the Petitioner, the Petitioner paid wages directly to these employees, and withheld and remitted withholding to appropriate Federal and state taxing authorities. In addition to maintaining a leased office in the State of Delaware, the Petitioner maintained separate bank accounts, actively managed its corporate assets and performed all requisite accounting and business functions, including the preparation of annual royalty invoices, financial statements and quarterly tax reports from within the State of Delaware. **At no time did the Petitioner conduct any business within the State of Maryland, nor was any business conducted on its behalf within this State.**

(e) During certain of the years at issue, the Petitioner received royalty income from licensing its intellectual property rights to third parties (i.e., parties other than Crown or a Crown affiliate).

(f) The Comptroller issued an Income Tax Notice of Assessment against the Petitioner dated May 13, 1996. The Petitioner timely requested an informal conference, which conference was held on August 7, 1996.

6. That the assessment made against the Petitioner is erroneous, arbitrary and illegal for one or more of the following reasons:

(a) The Respondent's assessment fails to account for the fact that the Petitioner is a validly formed, fully functioning, independent entity and not a "phantom or bookkeeping entity" as asserted by the Comptroller.

(b) The Respondent's assessment relies inappropriately and mistakenly on *Comptroller of the Treasury v. Armco Export Sales Corporation*, 82 Md. App. 429 (1990), and *Comptroller of the Treasury v. Atlantic Supply Company*, 294 Md. 213 (1982), which cases are factually and legally distinguishable from, and inapposite to, the instant case.

(c) The Respondent's assessment fails to acknowledge that pursuant to both the Commerce Clause of the United States Constitution, and the Due Process Clause of the United States and the Maryland Constitution, and court interpretations thereof, the Petitioner lacks the requisite nexus with the State of Maryland to be subject to corporate income taxation within this State.

(d) Assuming, *arguendo*, that the requisite nexus with the State of Maryland exists to impose Maryland corporate

income tax on the Petitioner, the Respondent erred in using the Petitioner's *parent's* apportionment factors and not the Petitioner's apportionment factors, in disregard of Sections 10-402 and 10-811 of the Tax-General Article of the Annotated Code of Maryland, and numerous court decisions precluding consolidated corporate tax filings and mandating separate return treatment for members of an affiliated group of corporations.

(e) Assuming, *arguendo*, that: (i) the requisite nexus with the State of Maryland exists to impose Maryland corporate income tax on the Petitioner; and (ii) the Petitioner's parent's apportionment factors, as set forth on the Petitioner's parent's Maryland income tax returns, should be used in determining the Petitioner's tax liability, then the statute of limitations applicable to the Petitioner's parent should control this assessment, and preclude any assessment for the 1989 and 1990 tax years pursuant to Section 13-1101 of the Tax General Article of the Annotated Code of Maryland. If such statutory provision is not an absolute bar to such assessment, the Petitioner avers that the Comptroller has the burden of proving the existence of an exception to the general statute of limitations. *World Book Childcraft International, Inc. v. Comptroller*, 67 Md. App. 424 (1986).

(f) All interest and penalty forming a part of the assessment should be waived for reasonable cause pursuant to Sections 13-606 and 13-714 of the Tax General Article of the Annotated Code of Maryland.

7. That the Petitioner submits that the Court should review the question of whether the Petitioner is liable for

corporate income tax, interest and penalty in the amounts set forth in the Notice of Final Determination of the Hearing officer, or in any amount.

Dated: March 20, 1997.

Respectfully submitted,

s/ Robert J. Carson
Robert J. Carson

s/ Daryl J. Sidel
Daryl J. Sidel

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## APPENDIX I — RESPONDENT'S MEMORANDUM OF LAW RECEIVED OCTOBER 15, 1999

**IN THE**
**CIRCUIT COURT FOR BALTIMORE CITY**

Case No. 24-C-99-002388AA

COMPTROLLER OF THE TREASURY,

Petitioner,

v.

CROWN CORK & SEAL CO.
(DELAWARE) INC.

Respondent.

**RESPONDENT'S MEMORANDUM OF LAW**

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*Appendix I*

[tables intentionally omitted]

## I. PRELIMINARY STATEMENT

Crown Cork & Seal Company (Delaware) Inc. (the "Respondent") submits this Memorandum of Law in opposition to the appeal of the Comptroller of the Treasury (the "Comptroller") of the reversal by the Maryland Tax Court (the "Tax Court") of an assessment of Maryland income tax, penalty, and interest against the Respondent

The Tax Court's decision was dated April 26, 1999. This matter was tried in the Maryland Tax Court before Judge Walter C. Martz, II on February 18 and 19, 1998.

The assessment reversed was dated February 21, 1997, and made assessments for tax years 1989 through 1993.

It is the Respondent's position that the Comptroller's appeal of the Tax Court decision is predicated on a gross misreading of the Tax Court's Memorandum of Grounds for Decision filed in the case (the "Decision").

In a desperate attempt to find legal error, the Comptroller has produced a strained and dubious reading of the Decision. According to the Comptroller, the Tax Court reversed the Comptroller's assessment on the Constitutional grounds that a taxpayer's physical presence is required in the taxing state.

The Comptroller states at the outset of its Memorandum of Law filed with this Court that the Tax Court's decision was "based on its view that the Commerce Clause of the

Constitution prohibited the Comptroller from imposing a Maryland income tax on [the Respondent]." Comptroller's Memorandum of Law, p. 1. Nor is this statement a mere rhetorical flourish on the part of the Comptroller, for there is more of the same. For example, the Comptroller states that "the Tax Court adopted a physical presence test for [the Respondent] . . . Moreover, it imposed a physical presence test notwithstanding such a test has been explicitly rejected in income tax cases by the Supreme Court of the United States. . . . It was legal error for the Tax Court to ignore the operating affiliate, to apply a physical presence test, and to deny that [the Respondent] had nexus with Maryland; that legal error requires that the decision of the Tax Court be reversed." Comptroller's Memorandum of Law, p. 3. Finally, the Comptroller states that the Tax Court was "imposing a physical presence test. . . ." Comptroller's Memorandum of Law, p. 32.

It is the Respondent's position that no such Constitutional analysis formed the basis of the Tax Court's holding. Under *Armco* (discussed at § IV-A), a true phantom corporation may be subjected to Maryland income tax even if that corporation has no physical presence in the State of Maryland. The Tax Court followed this aspect of *Armco*, thereby agreeing that there are situations where physical presence is not necessary to tax. The Tax Court merely refused to expand *Armco* to other than true phantom corporations.

In addition, the Tax Court went out of its way to state that it was *not* adopting a physical presence test. For example, in the Tax Court's Memorandum of Grounds for Decision in *SYL, Inc., v. Comptroller of the Treasury* (which decision is

incorporated by reference into the Decision), the Tax Court stated "we hesitate to expand the *Quill* physical presence requirement for taxes other than sales and use." S*YL* decision, p. 6. It is shocking that in an attempt to find legal error, the Comptroller would attribute to the Tax Court a doctrine that it not only failed to embrace, but went out of its way to avoid.

It is also surprising that the case described by the Comptroller in its Memorandum of Law bears little relationship to the case set forth by the Comptroller in the Notice of Final Determination, and to the case litigated in the Tax Court. Counsel for the Comptroller cogently summarized the Comptroller's case in his opening statement before the Tax Court. He stated:

> This case presents the question of whether the principles that were established by the Court of Special Appeals in the *Armco Export* case, and by the Court of Appeals in the *Atlantic Supply* case are applicable to [the Respondent] . . . The answer to that question will depend on whether the Court finds [the Respondent] had substantial economic substance. Tran. (I) 20-21.[1]

In other words, at trial the Comptroller presented this case as one that turned on the factual question of whether the Respondent was a "phantom," which turned on whether the Respondent had "substantial economic substance." This was, in fact, the case that was litigated in the Tax Court. This was

1. References to "Trap. (I) __" are to Volume I and references to "Trap. (II) " are to Volume II of the transcripts of the trial held on February 18 and 19, 1998, in the Tax Court.

the case to which the Decision was addressed. There was no mention of *Geoffrey, Inc. v. South Carolina State Tax Commission* in the Comptroller's Notice of Final Determination, nor when the Comptroller's counsel outlined its case for the Tax Court. It is the Respondent's contention that this case was properly summarized by counsel for the Comptroller in his opening statement, and that this case can be disposed of on the facts, without recourse to dubious interpretations of the United States Constitution or even more dubious decisions from outside this state.

Since it is the Respondent's position that the Comptroller grossly misstated the holding of the Tax Court, the Respondent will set out, as clearly as possible, what that holding actually was. With respect to the principal issue in this case, whether the Respondent had sufficient nexus with the State of Maryland for the latter to impose an income tax on the Respondent, the reasoning of the Tax Court was as follows:

> 1. Substantial nexus must exist between the State of Maryland and the Respondent if the State of Maryland is to impose an income tax on the Respondent (this principal was adopted by the Tax Court pursuant to the interpretation of the Commerce Clause of the United States Constitution by the Supreme Court in *Quill v. North Dakota;* see the discussion at § IV-B-3 of this Memorandum).
>
> 2. A taxpayer's nexus with a state can be either actual or attributed from a related party.

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3. The Respondent had no actual nexus with the State of Maryland (this appears to have been stipulated at the Tax Court by both the Comptroller and the Respondent, and, in any event, constituted a finding of fact by the Tax Court).

4. As a result of item 3, substantial nexus between the State of Maryland and the Respondent can only exist if it is attributed to the Respondent from a related party (in this case the Respondent's parent).

5. Based on its reading of *Comptroller v. Armco Export Sales Corp.*, the Tax Court concluded that nexus attribution "was found proper by the Maryland courts only when the entities were true phantom corporations." (Decision, p. 2).

6. The Tax Court found, as a matter of fact, that "the evidence presented clearly shows that [the Respondent] is not a phantom or sham corporation." (Decision, p. 2).

7. Accordingly, nexus cannot be attributed to the Respondent.

8. Since nexus between the State of Maryland and the Respondent does not exist actually, nor can such nexus be attributed, there is no nexus

between the State of Maryland and the Respondent.

9. The State of Maryland may not, therefore, impose an income tax on the Respondent.

## II. THE STANDARDS FOR REVIEW OF APPEALS FROM THE MARYLAND TAX COURT TO THE CIRCUIT COURT

An appeal to the Circuit Court from a final order of the Maryland Tax Court is governed by the provisions of §§ 10-215 and 10-216 of the State Government Article of the Annotated Code of Maryland. See § 13-532(b) of the Tax General Article of the Annotated Code of Maryland.

The Circuit Court's review of a final order of the Maryland Tax Court is limited. See *Comptroller v. Diebold, Inc.*, 279 Md. 401 (1986). The Circuit Court is required to affirm the Tax Court's decision unless the Circuit Court determines that the Tax Court was erroneous as a matter of law, or that the Tax Court's decision was not supported by substantial evidence. *Comptroller v. Washington National Arena Ltd. Partnership,* 66 Md. App. 416 (1986).

In *United Parcel Service, Inc. v. Comptroller,* 69 Md. App. 458 (1986), the Maryland Court of Special Appeals (elaborating on the principles set forth in *Ramsay, Scarlett & Co. v. Comptroller,* 302 Md. 825 (1985)) set forth the following three-step analysis for Circuit Court review of a Tax Court decision:

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1. First, the reviewing court must determine whether the agency recognized and applied the correct principles of law governing the case. The reviewing court is not constrained to affirm the agency where its order is premised solely upon an erroneous conclusion of law.

2. Once it is determined that the agency did not err in its determination or interpretation of the applicable law, the reviewing court next examines the agency's factual findings to determine if they are supported by substantial evidence, i.e., by such relevant evidence as a reasonable mind might accept as adequate to support a conclusion. "It is the agency's province to resolve conflicting evidence, and, where inconsistent inferences can be drawn from the same evidence, it is for the agency to draw the inference."

3. Finally, the reviewing court must examine how the agency applied the law to the facts. This, of course, is a judgmental process involving a mixed question of law and fact, and great deference must be accorded to the agency. The test of appellate review of this function is "whether, . . . a reasoning mind could reasonably have reached the conclusion reached by the [agency], consistent with a proper application of the [controlling legal principles]." [citation omitted.]

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The Respondent will clearly show in this Memorandum that the Tax Court recognized and applied correct principles of law to this case; that the Tax Court's findings of fact were supported by more than substantial evidence; and that it would be difficult for any "reasoning mind" to have reached any other conclusions than those reached by the Tax Court.

## III. STATEMENT OF FACTS

### A. *Crown, Cork & Seal Company, Inc.*

Crown, Cork & Seal Company, Inc., a Pennsylvania corporation ("Crown Parent"), is a publicly held corporation engaged in the worldwide manufacturing and sale of metal cans, crowns, and closures for bottles, can filling machines, and plastic bottles and containers. Stip. ¶2.[2] The company was founded in Baltimore, Maryland, in 1892 and is currently headquartered in Philadelphia, Pennsylvania. Its stock is traded on the New York Stock Exchange. Tran. (I) 42-43.

In the late 1960's, Crown Parent owned 26 manufacturing plants in the United States and had annual sales of approximately $300 million. Tran. (I) 45. In the late 1980's and early 1990's, Crown Parent embarked upon a period of rapid expansion. This growth spurt was a deliberate reaction to consolidation occurring among Crown Parent's customers. Tran. (I) 55.

The strategy of growth and acquisition was successful. In December 1989, Crown Parent acquired one of its major competitors, Continental Can of Canada. Tran. (I) 58.

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2. References to "Stip. ¶__ are to the Stipulation executed by Respondent and the Comptroller, which was admitted in evidence as Joint Exhibit 1 before the Tax Court.

The following year, Crown Parent purchased a metal operation in the United States. That was followed, in 1991, by the acquisition of a number of foreign and domestic competitors. Tran. (I) 58. In 1996, Crown Parent consummated its largest acquisition. As a result of these acquisitions and internal growth, Crown Parent today has 280 manufacturing plants in 56 countries, and revenue of approximately $9 billion per year. Tran. (1) 45-46.

As Crown Parent embarked upon this aggressive acquisition campaign, it sensed that it was becoming an acquisition target. The late 1980's and early 1990's were marked by frenetic acquisition activity, often hostile to management. In 1989, Crown Parent possessed a balance sheet that was the envy of many publicly held companies. It had no debt. Tran. (I) 57. This made Crown Parent an ideal target for a hostile takeover. This concerned the company's management. Tran. (I) 57.

During the years in issue, Crown Parent owned and operated manufacturing plants in Baltimore City, Harford County, and Wicomico County, Maryland. Stip. ¶4. Crown Parent timely filed all Maryland corporate income tax returns for the periods in question. Stip. ¶5.

B. *Creation of the Respondent.*

The Respondent (Crown Cork & Seal Co. (Delaware), Inc.) was formed principally as a hostile takeover defense. Tran. (I) 56-57. Decision, p. 2 ("[the Respondent] is a viable

entity established for valid business purposes, including the protection of valuable intellectual property rights from hostile takeovers. . . .") By Crown Parent contributing its valuable trademarks and patents (collectively, "intellectual property") to a wholly owned, single purpose subsidiary, these valuable assets could be insulated from hostile takeovers and deployed to prevent them. The testimony of the Respondent's general counsel on this point was not only uncontradicted, it was corroborated twice over.

Dr. A. C. Sondhi, an independent investment and financial advisor who has studied finance and intellectual property subsidiaries for over 20 years, and qualified as an expert in the Tax Court, testified that while there are "several reasons" for establishing an intellectual property subsidiary, "probably the most important reason and . . . how it all began to some extent" was as a hostile takeover defense. Dr. Sondhi further testified that "in the event that the company is the object of a hostile takeover they can defend themselves by either selling or otherwise using that valuable asset, the intellectual property, to ... borrow so much money as to make the takeover untenable to the hostile bidder". Tran. (I) 188-189.

In addition, Arthur Seidel, Esq., an independent intellectual property attorney with over 50 years experience in the field, who qualified as an expert in the Tax Court, testified that "the most common [reason for forming intellectual property subsidiaries] is the anti takeover . . . you can borrow against it and prevent a takeover by running up a large amount of debt, or you can sell it and get a lot of money into the company". Tran. (I) 242.

It was also envisioned by Crown Parent's senior executives that placing intellectual property in one entity could help control and manage that asset as the Crown corporate family grew by acquisition, as well as provide the base for favorable financing, if needed. Tran. (I) 56-57.

Before Crown Parent's general counsel and senior executives approved the formation of an intellectual property protection company (an "IPPC"), they sought the advice of independent experts. Crown Parent's general counsel, Richard Krzyzanowki, testified: "We approached law firms. We approached accounting firms. We approached engineering firms. We talked to the outside intellectual property law firms." Tran. (1) 57. All of these professionals agreed that in view of Crown Parent's acquisition plans, and its posture as a hostile takeover target, forming an IPPC was a prudent business decision.

It was only *after* the decision was made to organize an IPPC that Crown Parent, on advice of outside counsel, determined where that entity should be incorporated. Tran. (1) 57-58. Mr. Krzyzanowksi also testified that no third party had any arrangement with Crown Parent or the Respondent to be compensated in connection with this transaction as a function of state tax savings. Tran. (I) 60.

Once it was determined that Crown Parent's valuable intellectual property rights would be conveyed to an IPPC, those intellectual property rights were valued by an independent appraiser. That appraisal also determined an appropriate royalty rate for licensing that property.

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Based on the recommendation of outside counsel, the Respondent was formed as a Delaware corporation. Crown Parent contributed all of its valuable domestic intellectual property rights to the Respondent in exchange for all of the Respondent's issued and outstanding stock. All documents necessary and appropriate to create and evidence this transaction were duly prepared.

After the intellectual property was assigned to the Respondent, the Respondent licensed the right to use those assets to Crown Parent. In exchange for that license, Crown Parent was required to pay a royalty to the Respondent at the rate set forth in an independent appraisal. The royalty was actually paid. Expert testimony indicated that the royalty rate was "very low." Tran. (1) 243.

At all times during its existence, the Respondent had business cards in the hands of its officers, and signage at its principal place of business in Delaware. Tran. (I) 53, 74. In addition, the Respondent maintained an office and bank accounts in Delaware and had employees performing services pursuant to written employment agreements. Tran. (I) 71-72.

At no time did the Respondent own or lease tangible personal or real property in the State of Maryland. Stip. ¶8 At no time did the Respondent have employees in the State of Maryland. Stip. ¶9. At no time did the Respondent have bank accounts in the State of Maryland. Stip. ¶10.

It is true, as the Comptroller notes repeatedly in its Memorandum of Law, and during the trial in the Tax Court,

that the Respondent was an entity with a large amount of income and a small amount of expenses. This, however, does not imply that the Respondent was a "phantom." Dr. Sondhi testified at trial that he has seen many examples of single-purpose subsidiary corporations with large income and small expenses. He mentioned that "Sears Acceptance Corporation is a great example of that. They used to borrow in the open market about a billion dollars a day. And I think they had less than twenty employees. . . ." Tran. (I) 197-198. It is no wonder that the Respondent, with far less gross receipts, had far fewer employees. However, no one would seriously argue that Sears Acceptance Corporation, one of the largest finance companies in the country, is a "phantom" corporation.

The Comptroller also argued in its Memorandum of Law, and at the Tax Court, that there was no evidence that the Respondent was actually used for any business purpose other than protection against a hostile take-over. Again, Dr. Sondhi, with his vast experience in this area, indicated that it is not uncommon for subsidiaries to be organized for a purpose, but for that purpose not to be realized until many years after the date of organization. Dr. Sondhi specifically mentioned subsidiaries organized by IBM and AT&T as examples of subsidiary corporations organized for specific purposes, but where the usage for that purpose was deferred for a number of years. Tran. (I) 196.

C. *The First Audit.*

In 1993, the Comptroller commenced an audit of Crown Parent for tax years 1989, 1990 and 1991 (the "First Audit"). Tran. (II) 12. Jeffrey Marks of the Comptroller's office

performed the First Audit. Tran. (II) 12-13. Despite the fact that Mr. Marks acknowledged that "the existence and the income and expenses of [the Respondent] are clearly shown on the - 89 return" and that the return was "obtained as part of [the] audit" of Crown Parent, no audit was initiated of the Respondent, and no assessment was made with respect to the Respondent. Tran. (II) 25.

There is no question that Crown Parent supplied sufficient information during the First Audit to enable the Comptroller to determine the existence of a Delaware IPPC. Mr. Marks testified that the reason no audit of the Respondent was initiated during the First Audit was that "during the earlier audit I was not aware about the Delaware holding companies. The *Geoffrey* case had not come out." Tran. (11) 25. Mr. Marks was asked, "Had you been looking for the existence and for the taxable income and for the expenses of [the Respondent] at the time [of the First Audit], you would have clearly seen these things by virtue of at least the 1989 and 1990 Maryland returns with their attachments?" Mr. Marks answered, "That's correct." Tran. (II) 29.

The Respondent issued a *subpoena duces tecum* to the Comptroller to produce his First Audit file at the trial. The Corporation Income Tax Audit Program covering the First Audit is contained in this file. The Program is just what its name denotes, a program describing the steps that an auditor should take during an audit. Step 1 .N in the Program (shown on p. 2) requires the auditor to: "Review corporate affiliations and note filing status of related companies in Maryland." Step 4.E.4 (found on p. 11. requires the auditor to review: "*Spreadsheet(s)* identifying separate income and expense for

each entity of a consolidated group. (i.e.: Income Statement, Balance Sheet for each corporation under review)." Step 4.E.4 is checked in the box marked "Yes," thereby denoting that Mr. Marks actually reviewed such a spreadsheet. Mr. Marks wrote in the Explanation block for Step 133 (found at p. 17): "Discussed... requirement for DISC to file in Md."

It is clear, therefore, that not only was the information necessary to discern the Respondent's existence available to the Comptroller during the First Audit, but information relating to the Respondent was actually reviewed by the Comptroller's office during the audit.

The notation regarding the DISC requirement is reiterated in a Confidential Narrative dated 10/22/92 which is also found in Exhibit 54. On p. 6 of this Narrative, Mr. Marks has written the following in his handwriting:

> "Disallowed DISC modif. — DISC does not file in Md.
>
> DISC required to file in Md based on Court case [the 1990 *Armco* decision]. Revised Corp. Income Tax Computation for 1989 & 1991 — T/P did not."

It is also abundantly clear, therefore, that the auditor was well aware of the *Armco* decision at the time of his audit of the 1989-90 tax years and indeed disallowed Crown's income tax computation in order to require its DISC income to be included. As will be seen below, the *Armco* case is the linchpin upon which the Comptroller rests his theory that

the Respondent is subject to taxation in Maryland because it "lacked substantial economic substance."

In other words, both the facts and the law upon which the Comptroller now relies to tax the Respondent were known to the auditor at the time of the First Audit.

Nevertheless, the First Audit made no adjustment to the income of Crown Parent or the Respondent as a result of the Respondent's disclosed existence as a Delaware IPPC.

D. *The Second Audit.*

Two years later, Mr. Marks was again assigned to audit the Maryland income tax returns of Crown Parent. At this time, Mr. Marks indicated that he "was aware of holding company cases like the *Geoffrey* case in literature and accounting journals." Tran. (II) 5. Mr. Marks testified that he reviewed "the consolidated federal return carefully and saw what appeared to be a Delaware holding company." Tran. (II) 6. Despite the fact that the Respondent had existed for all three years previously examined in the First Audit, the appearance of a Delaware IPPC precipitated an audit of the Respondent for its *entire* existence (tax years 1989, 1990, 1991, 1992 and 1993), which included the three years previously audited.

The audit of the Respondent was perfunctory at best. Mr. Marks initially testified that he visited the Respondent's office in Delaware, surely a significant endeavor when determining whether a taxpayer is a phantom. Tran. (II) 7. When confronted with the actual location of the Respondent's

Delaware office, however, Mr. Marks admitted that he must have been mistaken in thinking that he visited the Respondent's office, and testified that he must have been "at another building altogether". Tran. (II) 43.

Further, Mr. Marks testified that he did not ask to meet with George Warren, the individual responsible for the day-to-day operation of the Respondent's business in Delaware. Tran. (II) 46. Mr. Marks also testified that he never asked to visit the Respondent's offices in Delaware to review records and files. Tran. (II) 46. Finally, despite the fact that the Respondent's financial statements reflected significant third-party income labeled "South Africa," Mr. Marks admitted that he did not know at the time of the audit "who the owner was of the South African company that paid that royalty." Tran. (II) 59.

E. *The Comptroller's "Phantom" Culture.* Perhaps of equal — or greater — importance than the Second Audit was the decision by the Comptroller's office in 1995 to audit and assess all Delaware IPPCs that crossed its path.

Patrick White came to the Comptroller's office in October, 1993, as a hearing officer/tax consultant. He was promoted to a staff legal advisor position in 1995, with a specialty in corporate income taxation. Tran. (II) 62.

The Comptroller's office became interested in Delaware holding companies in mid-1995 immediately after Mr. White became a staff legal advisor. Two events were important in the "evolution" of the Comptroller's position with respect to these companies, which had not previously been a matter of concern. Tran. (II) 65.

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First, the *Geoffrey* case was decided in South Carolina in 1993 and "precipitated a whole lot of interest . . . from audit departments around the country, inclusive of Maryland, as to what the Delaware holding companies were all about". Tran. (II) 65.

Second, Mr. White attended a seminar in Georgetown in May of 1995 which he testified was a "watershed event, from my standpoint at least, in getting an understanding of how some of these companies could be set up in Delaware very inexpensively and still book tremendous amounts of income." Tran. (II) 66. Mr. White went to the lobby during an intermission and saw business service providers offering information and brochures for an "office in a box". Tran. (II) 70. These vendors were also advising that Delaware holding companies of this type had never failed on audit before. Tran. (II) 70. Although the Comptroller's office did not then "know a lot" about IPPCs or finance companies, Mr. White proceeded to do legal research with respect to intellectual property law and to examine the IPPCs' trademarks and patents and the manner in which they had been acquired and licensed back to their parent or affiliated companies.

Mr. White was also involved in attempting to review the books and records of the audited companies from an accounting standpoint as well. Tran. (II) 71-73, 157-59.

According to Jeffrey Marks' testimony, Mr. White then proceeded to implement his thoughts with respect to these "phantom companies." Mr. White instructed the auditors how to audit these companies, even though there had not been

any previous case dealing with such a company, nor any statute, rule or regulation passed with respect to them, nor any earlier audit history with respect to them. In addition to personally instructing and working with the auditors on the audits of the IPPCs, Mr. White prepared a written narrative for the auditors to use during their audits. The narrative consisted of a series of questions regarding factors and characteristics to look for. Tran. (II) 29-30. The Comptroller's office in due course prepared and adopted a "Potential Phantom Companies Checklist" which set forth 18 criteria or factors to be investigated in auditing an IPPC. Blanks were present on the form for information to be filled in by the auditor. The Respondent's Exhibit 55. Mr. Marks testified that the criteria set forth on the Potential Phantom Companies Checklist "essentially codified and put in writing those factors and criteria which [we were] looking for when [we] audited Crown, Delaware in 1995 and 1996." These criteria "formalized" the Comptroller's policy and procedures. Tran. (II) 34.

In addition to working with the auditors and preparing the narrative, which in turn gave rise to the Potential Phantom Companies Checklist, Mr. White also conducted training sessions for the auditors where he discussed the factors and criteria for an IPPC audit. Tran. (II) 31. Mr. White, according to his own testimony, also worked closely with the hearing officers involved in these cases, suggesting to them what documents and/or evidence they should require and review and actually writing the intellectual property portions of their opinions for them, as he did in this case. Tran. (II) 72-73, 177-78.

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A distinctive lexicon was developed by the Comptroller's office with respect to these IPPCs. Mr. Marks testified they were often called "shell companies" or "bookkeeping entities." Tran. (II) 40. They were also sometimes referred to as "tax havens." Tran. (II) 41. Mr. White's own testimony is replete with examples of this vocabulary.

In summary, the Comptroller's office starting in 1995 prepared its own private regulations with respect to IPPCs. While there have been at least 50-100 IPPC audits since then, virtually none of the companies have escaped the inevitable assessment resulting from the Comptroller's private (and unpublished) regulations. Tran. (II) 194-96.

## IV. ARGUMENT

### A. *No Reversible Error Exists in the Tax Court's Holding that the Respondent is Not a Phantom Corporation.*

Despite the Comptroller's attempt to transform the Tax Court's factual holding into an interpretation of law, the truth is that the primary holding in this case is factual in nature. The Decision states clearly that "the factual resolution for the Court is whether nexus exists between Petitioner and Maryland." For a number of reasons, the Tax Court held that it was inappropriate to attribute the nexus that existed between the State of Maryland and Crown Parent to the Respondent.

## *Appendix I*

1. *The Comptroller's Attempt to Expand Comptroller v. Armco.*

The only reported Maryland decision holding that a so-called "phantom or bookkeeping entity" can acquire Maryland nexus solely because of the presence of a unitary affiliate is *Comptroller v. Armco Export Sales Corp.*, 82 Md. App. 429 (1990), *cert. denied,* 498 U.S. 1088 (1991). In essence, the Tax Court found that the Comptroller's attempt to apply *Armco* to the case at hand represented a substantial expansion of a narrowly drawn doctrine that did not even come into existence until after the Respondent was organized.

*Armco* dealt with the State's ability to tax domestic international sales corporations ("DISCs"). A DISC is strictly a creature of the Internal Revenue Code. As stated in *Armco*, a DISC "is a phantom bookkeeping entity corporation created under the federal tax law as a device to encourage exports through an exemption from otherwise taxable profits." *Armco* at 430.

The Internal Revenue Service recognizes that DISCS are corporations without substance that receive special consideration by dint of federal legislation. See U.S. Income Tax Regulations Sec. 1.992-1(a) (". . . the rules contained in this paragraph [regarding DISCs] constitute a relaxation of the general rules of corporate substance otherwise applicable under the [Internal Revenue] Code"). In other words, but for a legislative mandate, the IRS would not recognize DISCs for tax purposes. It is worth noting that the IRS has never questioned the substance of a Delaware IPPC. The pertinent provisions of this Regulation are attached as Appendix A.

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The DISCs at issue in *Armco* had *no* employees, *no* property, and were *entirely dependent* on their parent corporations for income. In addition, the DISCs served no conceivable business purpose other than securing Federal income tax benefits. Finally, and perhaps most importantly, in subjecting DISCs to Maryland income tax, the *Armco* court noted a clearly expressed "legislative intent to tax DISCs" since the Maryland General Assembly had enacted a statute expressly subjecting them to Maryland income tax. *Armco* at 437, citing Annotated Code of Maryland, Article 81, Section 280A(c)(7) (under prior income tax law) which was added in 1978.

None of these factors applies to the Respondent. Unlike the DISCs in *Armco*, the Respondent was "established for valid business purposes, including the protection of valuable intellectual property rights from hostile takeovers of the parent corporation." Decision, p. 2. Unlike the DISCs in *Armco*, the Respondent had physical presence (through a leased office) in the State of Delaware, "had separate bank accounts and employees performing services pursuant to written employment agreements," (Decision, p. 2) and "received royalty income from third parties (other than Crown or an affiliate) during some of the years in controversy." Decision, p. 2. Finally, there has been no expression of legislative intent to tax IPPCs. In fact, in its 1998 session, the General Assembly declined to even vote on proposed legislation that would have subjected IPPC's to Maryland income tax. See House Bill 682, "Income Tax Out-of-State Holding Companies Doing Business in Maryland," introduced on February 14, 1998, and withdrawn on March 16, 1998.

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It is hard to imagine two corporations more different than the DISCs in *Armco* and the Respondent.

In short, the Tax Court found that *Armco* "only applies to entities with no substance whatsoever." SYL decision, p. 5. Based on the facts presented at trial, the Tax Court found that the Respondent had economic substance a plenty. Hence *Armco* could not be used to attribute nexus to the Respondent. The factual findings made by the Tax Court are supported by uncontradicted evidence, and present no grounds for reversal. It is hard to see how the Tax Court's failure to expand *Armco* beyond its stated borders constitutes reversible error.

2. *The Comptroller's Interpretation of Armco is Legally Incorrect.*

The Comptroller takes the view that for purposes of finding a lack of "substantial economic substance" under *Armco*, the business reasons for establishing a corporation are irrelevant. Tran. (II) 175 (testimony of Patrick White: "business reasons are not relevant to our approach. . . . What the reasons were for setting it up doesn't really matter.")

Under an *Armco* analysis nothing should be more germane to the finding of a "phantom" corporation than its business purpose for existing. The language used by the Court of Special Appeals to describe the DISCs in *Armco* is replete with implications that these DISCs had no conceivable non-tax business reason for existing.

The Tax Court found that the uncontradicted evidence in this case showed that Respondent was formed for valid

non-tax business reasons. The principal reason was to deter a hostile takeover. Further business reasons for the organization of the Respondent were discussed and demonstrated in the testimony of Mr. Krzyzanowski, Dr. Sondhi and Mr. Seidel.

The importance of business purpose in determining the *bona fides* of Delaware IPPCs was underscored in the recent New York Division of Tax Appeals decision, *In re Express, Inc.*, DTA Nos. 812330, 812332 and 812334, 1995 N.Y. Tax Lexis 493 (N.Y.S. Div. of Tax Appeals, September 14, 1995). A copy of *In Re Express, Inc.*, is attached as Appendix B. In *Express*, the New York Division of Taxation "questioned the legitimacy and viability" of a group of Delaware IPPCs. Administrative Law Judge Alston stated that "if no business justification exists for the trademark companies . . . such companies were, in fact, 'shells'. . . ." The judge found that despite the absence of employees and third party income, "the trademark companies were viable corporations" formed for valid business reasons.

New York is not alone in finding that the business purposes for forming IPPCs are relevant to their tax status. In *Aaron Rents v. Collins*, Civil Action File D-96025 (Georgia Superior Court 1994), the court found that Aaron Investment Company, a Delaware trademark protection subsidiary of Aaron Rents, Inc., existed for "adequate, valid non-tax reasons," that the subsidiary "engaged in sufficient business activities to constitute a valid, separate and distinct corporate entity and that the formation and operation of Aaron Investment Company *was not* a *sham transaction*" (emphasis added). The court reached this conclusion despite

the fact that the subsidiary was dependent on its parent for *all* of its income. A copy of *Aaron Rents* is attached as Appendix C.

Accordingly, the Comptroller's reliance on *Armco* for the proposition that business purpose is irrelevant, is incorrect and out of step with recent holdings from other states.

B. *The Tax Court Did Not Commit Reversible Error in Failing to Hold that the Commerce Clause of the U. S. Constitution Permits Taxation of the Respondent.*

1. *Unitarity is a 'Red Herring'*

The Tax Court refused to follow the Comptroller's argument (raised for the first time in its Post-Trial Memorandum) that the Commerce Clause of the United States Constitution, and Supreme Court decisions applying the Commerce Clause to state taxation, permit the imposition of tax on the Respondent.

In its Memorandum of Law filed with this Court, the Comptroller makes much ado about the concept of "unitarity," and the fact that the Respondent is part of a unitary group of corporations. The fact is, the Respondent has never denied that it is part of a unitary group. The fact also is, however, as the Tax Court stated in the *SYL* decision, that "the unitary relationship between entities does not automatically establish nexus on all of the corporate entities in the unitary group. . . . The mere presence of an in-state affiliate of a unitary group does not confer nexus on a non-

phantom out-of-state affiliate of the same group [citation omitted]. In a unitary taxation scheme, the foreign corporation's income and factors may be included in determining the tax liability of the in-state affiliate. However, without nexus, the foreign corporation does not become subject to the taxing jurisdiction." *SYL* decision, p. 7.

Although the State of Maryland has implicit jurisdiction to tax unitary groups engaged in interstate commerce, as the Tax Court correctly noted, this jurisdiction is subject to the limitations set forth in the Commerce Clause and the Due Process Clause of the United States Constitution.

2. *The Due Process Clause.*

In *Shaffer v. Carter,* 252 U.S. 37 (1920), the United States Supreme Court held that the imposition of tax on a non-resident taxpayer was a valid exercise of a state's taxing power. The court determined that the Due Process requirements of the Constitution were satisfied since the taxpayer's property, from which the income to be taxed was derived, received the benefits conferred and protections afforded by the laws of the taxing state.

The Supreme Court's decision in *Shaffer* established a standard of fairness in state taxation that continues today. That standard suggests that if there is a sufficient connection between the taxing state and the non-resident taxpayer, and the tax imposed is fairly related to the non-resident taxpayer's in-state activities, the tax will be upheld under the Due Process Clause.

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3. *The Commerce Clause.*

The Commerce Clause prohibits states from unduly burdening interstate commerce. In 1977, the Supreme Court held that states were not barred from imposing a non-discriminatory tax upon the privilege of engaging in interstate commerce. In that case, *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977), the Supreme Court introduced a four factor test to which it has subsequently adhered. Under this test, a state tax will pass Constitutional muster if it: (i) is fairly apportioned; (ii) is applied to an activity that has substantial nexus with the taxing state; (iii) does not discriminate against interstate commerce; and (iv) is fairly related to the services provided by the taxing state.

*a. Quill.* In *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992), the Supreme Court provided its most extensive discussion of the Constitutional limits of state taxation. In *Quill*, the Court held that an out-of-state mail-order seller with no physical presence in the taxing state, that merely mailed catalogs into that state and filled orders by U.S. Mail and common carrier, was protected by the Commerce Clause from the imposition of a use tax collection responsibility in that state.

In reversing the North Dakota Supreme Court's decision, the U.S. Supreme Court held that the nexus requirements imposed by the Due Process Clause and the Commerce Clause "pose distinct limits on the taxing powers of the States." *Id.* at 305. With respect to the Due Process Clause, *Quill* stated that physical presence was not required. Rather, the Court ruled that "if a foreign corporation purposefully

avails itself of the benefits of an economic market" or purposefully directs its "efforts toward the residents of another state," and if subjecting the corporation to the state's tax and jurisdiction does not offend "traditional notions of substantial justice," then nexus sufficient to satisfy the Due Process Clause exists. *Id.* at 307.

However, the Supreme Court stated that a different standard must be applied under the Commerce Clause. In the Supreme Court's view, the Due Process Clause and Commerce Clause were "animated by different constitutional concerns and policies." The Court found that "substantial nexus" was required under the Commerce Clause, and that required more than the "minimum contacts" necessary to satisfy the Due Process Clause. **At least in the context of a use tax collection responsibility, the Supreme Court held that the Commerce Clause's "substantial nexus" standard required physical presence in the taxing state.**

Although *Quill* involved the Constitutionality of a use tax collection responsibility, the Respondent submits that there is no substantive Constitutional difference between a use tax and a net income tax. In fact, fairness may dictate that the level of contacts required for a state to merely impose an obligation to collect and remit a use tax is lower than the level of contacts required to impose a direct income tax.

Despite the Comptroller's protestations to the contrary, the Supreme Court's analysis of the Constitutional nexus requirements under both the Due Process and Commerce Clauses in *Quill* was not limited to a use tax. The Supreme Court implicitly made this point when it stated, "although

we have not, in our review of other types of taxes, articulated the same physical presence requirement . . . established for sales and use taxes, that silence does not imply repudiation of [these rules]." *Id.* at 314. In fact, the Supreme Court expressly noted that in all of its prior cases upholding taxation against Commerce Clause challenges, the taxpayer had physical presence in the taxing state. *Id.* at 314.

While the Respondent acknowledges that this issue was not *expressly* decided in *Quill*, the Supreme Court noted that it had cited the physical presence requirement in cases involving taxes other than use tax collection. *Quill* at 311. See for example, *Goldberg v. Sweet,* 488 U.S. 252 (1989) (telecommunications excise tax); *Commonwealth Edison Co. v. Montana,* 453 U.S. 609 (1981) (severance tax); *Mobil Oil Corp. v. The Commissioner of Taxes,* 445 U.S. 425 (1980) (corporate income tax).

So, while the Tax Court stated clearly that it was not imposing a physical presence requirement, it is the Respondent's position that such a holding, had it been made by the Tax Court, would not have been out of step with the Supreme Court's analysis of the Commerce Clause.

b. *Geoffrey. As* noted above, the Tax Court did not hold, as a matter of law, that physical presence was necessary to endow the State of Maryland with the Constitutional power to tax. The Tax Court merely said, citing *Quill*, that "substantial nexus" is necessary. The Comptroller, on the other hand, appears to believe that permitting the use of intellectual property in a state is sufficient to establish substantial nexus with that state under the Commerce Clause.

In this belief, the Comptroller relies on *Geoffrey Inc. v. South Carolina Tax Commission,* 437 S.E.2d 13 (S.C. 1993), *cert. denied* 114 S.C. 550 (1993), a case in which the South Carolina Supreme Court held that licensing an intangible asset in South Carolina constituted "substantial nexus" under the Constitution.

While the Comptroller applauds *Geoffrey,* and urges its adoption in Maryland, *Geoffrey's* Commerce Clause analysis is, to be charitable, problematic. After citing the four factor *(Complete Auto Transit)* test, the South Carolina Supreme Court ignored the Commerce Clause issues discussed in *Quill.*

In *Geoffrey,* the South Carolina Supreme Court gave no indication that it even recognized the real Commerce Clause issue. That court did not consider whether the concerns that lead to the Supreme Court's reaffirmation of the physical presence test for use tax collection in *Quill* were equally applicable to an income tax. In addition, the South Carolina Supreme Court failed to perform the careful weighing of issues and balancing of interests that the Supreme Court clearly called for in *Quill.* In fact, *Geoffrey* appears to have assumed that nexus sufficient for the Due Process Clause is nexus sufficient for the Commerce Clause. If there is one clear lesson from *Quill,* it is that such an assumption is wrong (". . . a corporation may have the 'minimum contacts' with a taxing state as required by the Due Process Clause, and yet lack the 'substantial nexus' with that State as required by the Commerce Clause"). *Quill* at 313.

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*Geoffrey's* cavalier treatment of the Commerce Clause was recently rejected in a well-reasoned opinion by the Administrative Law Division of the State of Alabama. *Cerro Copper Products, Inc. v. The Alahama Department of Revenue,* Docket No. F-94-444 (1995). In *Cerro,* the court stated that "a state is prohibited by the Commerce Clause from taxing an out-of-state taxpayer unless the taxpayer has at least some physical presence in the state." The *Cerro* court noted that the state of Alabama's attempt to tax an entity with no physical presence in the state was "based on the South Carolina Supreme Court's holding in *Geoffrey.*" The opinion then stated that "this opinion is a respectful dissent from *Geoffrey.*" A copy of *Cerro* is attached as Appendix D.

C. *The Tax Court Did Not Commit Reversible Error in Holding that the Comptroller's Assessment Violated CBS v. Comptroller.*

1. *Background.*

The Tax Court held, in the alternative, that even if the Respondent possessed substantial nexus with the State of Maryland, the Comptroller's assessment was invalid for want of rulemaking. The Tax Court addressed the reason for such an alternative holding, stating "[H]aving found that the requisite nexus to warrant the imposition of income tax on [the Respondent] does not exist, the issue of whether a regulation had to be promulgated becomes moot. However, due to the number of taxpayers involved and the likelihood of judicial review, we shall address the issue." *SYL* decision, p. 8.

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The Tax Court concluded that "the [Comptroller's] attempt to assert tax against non-nexus, non-phantom trademark protection companies as a result of their licensing of the use of their trademarks, trade names and service marks to entities which have a nexus with the State amounts to a substantially new or change in policy which can only be instituted through the rulemaking procedures. . . ." *SYL* decision, p. 8. In support of this holding, the Tax Court cited *CBS, Inc. v. Comptroller.*

2. *CBS.*

In *CBS Inc. v. Comptroller,* 319 Md. 687 (1990), the Maryland Court of Appeals held that the Comptroller may enact certain tax policies only prospectively, and then only by formal rulemaking.

*CBS* dealt with the manner in which the Comptroller apportioned advertising receipts of national broadcasting companies. For a number of years, CBS computed its Maryland income tax pursuant to the three-factor formula. *CBS* at 688. The taxpayer and the Comptroller stipulated that the taxpayer's method of apportionment "was reviewed during the audits of prior years . . . and no adjustment . . . was ever proposed." *CBS* at 690. Despite this prior history of acquiescing in the taxpayer's method of apportionment, "when the 1980 and 1981 returns were audited, the Comptroller for the first time insisted on the application" of a new apportionment method. *CBS* at 690. The question presented was whether the Comptroller's new policy required formal rulemaking.

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The Court of Appeals found that "the effect of the Comptroller's audit was to announce a substantially new generally applicable policy with respect to apportionment of the network advertising income of national broadcasting corporations." *CBS* at 699.

The Court of Appeals explicitly rejected the Comptroller's assertion that the authority granted the Comptroller in Tax General Article § 10-402(d) and COMAR § 03.04.01.03(G) gave the Comptroller the authority to enact this new policy without formal rulemaking. Quoting *Metromedia, Inc. v. Director, Div. of Taxation,* 97 N.J. 313, 478 A.2d 742 (1984), the *CBS* Court stated "it does not follow that, because [an agency] has statutory discretion, the manner in which this discretion is exercised is not governed by the standards that determine whether rulemaking or adjudication must be followed in a given case." *CBS* at 698.

The Maryland Court of Appeals held that the Comptroller's new policy could not be effected through ad hoc adjudication, but only pursuant to the formal rulemaking procedures of the Maryland Administrative Procedure Act. As a result, the Comptroller's position could not be applied retroactively. *CBS* at 699.

The holding in *CBS* is in accordance with the Maryland Administrative Procedure Act, State Government Article § 10-101 through 10-139, which requires that a change or implementation of policy by a state agency be accomplished by promulgating a regulation. In addition, the Administrative Procedure Act provides that regulations may only be promulgated prospectively. State Government Article § 10-101(g)(1).

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3. *The CBS Doctrine Applies to Both New Policies and Changed Policies.*

The Comptroller has asserted that CBS does not apply to the case at hand. Comptroller's Memorandum of Law, p. 42ff. The Comptroller's rationale is that *CBS* applies only to situations in which an administrative agency *changes* its position, not to situations in which an agency propounds a *new* one.

The Respondent submits that the Tax Court was correct in applying *CBS* to the case at hand, and that the Comptroller's analysis of *CBS* is doubly misguided. First, the Comptroller's position in this case does represent a change of position. Second, *CBS* is not limited to changed positions as contrasted with new ones.

a. *The Comptroller's position in this case represents a changed position.* Prior to its implementation of an aggressive audit policy of Delaware IPPCs, the Comptroller did have a position as to when foreign companies with no physical presence in Maryland should pay Maryland income tax. That policy was implicit in the fact that Crown Parent was audited in 1993 for tax years 1989 and 1990; that the existence of a Delaware IPPC was evident during that audit; and that the Comptroller did not see fit to assert any deficiency with respect to that company. See the trial testimony of Jeffrey Marks at Tran. (II) 29, as well as the discussion at § III-C above.

In addition, the Comptroller's prior policy was fully set forth in ADR No. 2, "Interstate Commerce Tax Act —

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Domestic and Foreign Corporations — Nexus Requirement — Apportionment of Corporate Net Income," promulgated by the Comptroller on January 1, 1989. In this Release, the Comptroller states that every "corporation . . . doing business within Maryland . . . shall file a true and accurate return of its income or loss for the taxable period." The Release defines "doing business within Maryland" as having a business location within Maryland, having a representative in Maryland, or engaging in certain activities other than those that do not cause an entity to be taxable under P.L. 86-272. Nothing in this Release, nor any other public release, pronouncement or regulation issued by the Comptroller has ever suggested that a corporation without property, employees, sales activity, or physical presence in the State of Maryland would be subject to Maryland income tax. A copy of the Release is attached as Appendix E.

b. *CBS is applicable to new administrative positions as well as changes in position*. Even the most cursory review of the Court of Appeals decision in CBS reveals that its holding was not limited to situations in which an administrative agency *changed* its policy. For example, in distinguishing *Consumer Protection v. Consumer Pub.*, 304 Md. 731 (1985), the Court of Appeals in CBS stated that the "administrative agency did not change existing law or even *formulate* rules of widespread application." *CBS* at 694 (emphasis added). In distinguishing *CBS* from another case, the Court stated that the latter "was not a case in which materially modified *or new standards* were applied *retroactively. . . .*" *CBS at 694 (emphasis added). Indeed, the CBS* Court specifically noted that *CBS* involved a *new policy*: "the effect of the Comptroller's audit was to announce a

substantially *new* generally applicable policy". *CBS* at 699 (emphasis added).

In fact, any distinction between a new and a changed policy would run counter to the Administrative Procedure Act. The definition of a "regulation" in State Government Article § 10-101(g) provides that "regulation" means "a statement *or* an amendment" (emphasis added). Clearly, the use of the phrase "statement *or* amendment" was designed to encompass both new as well as changed statements of policy.

The requirement of administrative rulemaking in instances of both new and changed policies is not unique to *CBS*. It can be found in the Supreme Court decision on which CBS is predicated. In *SEC v. Chenery Corp.*, 332 U.S. 194 (1947), the Supreme Court stated "since the [Securities Exchange] Commission, unlike a court, does have the ability to make *new* law prospectively through the exercise of its rule-making powers, it has less reason to rely upon ad hoc adjudication to formulate *new standards* of conduct. . . ." *Chenery* at 202 (emphasis added). The administrative policy at issue in *Chenery* was a new policy.

4. *Reliance.*

The Comptroller seeks to further distinguish *CBS* from this case on the grounds that there was no detrimental reliance by the Respondent on the Comptroller's prior actions. The Comptroller attempts to distinguish this case from *CBS*, where the taxpayer's returns for prior years had been audited and approved by the Comptroller, on the grounds that it was

Crown Parent, not the Respondent itself who filed income tax returns with the State of Maryland. Comptroller's Memorandum of Law, p. 44 (especially, footnote 41).

This argument borders on sophistry. This case is only before this Court because during a routine audit of Crown Parent, the Comptroller's auditor had before him all the facts necessary to ascertain that a Delaware IPPC existed, and to audit that company. These facts are no different than those that existed in prior audits of Crown Parent. See § III-C of this Memorandum for a discussion of these facts. It is also ironic that while the Comptroller believes that the Respondent and Crown Parent are alter-egos, the Comptroller does not feel that the Respondent was entitled to rely on prior audits of Crown Parent. If the Comptroller is correct in its alter-ego theory, and if the activities of Crown Parent should be attributed to the Respondent for the purposes of finding nexus, then it is hard to understand why Crown Parent's reliance on prior audits should not also redound to the benefit of the Respondent.

5. *Summary*

The Respondent submits that the case at hand is virtually identical to *CBS*. Crown Parent's tax returns, taking the same position the Respondent is now forced to defend, had been previously audited without adjustment. The Respondent relied, and had every right to rely, on that prior audit as evidence of the acceptance of its position by the Comptroller.

In 1995, the Comptroller determined as a matter of internal policy that it would aggressively audit Delaware

IPPCs. It developed a theory on which to attack them and has now applied that theory to over 50 taxpayers. Tran. (II) 194.

For the first time in Maryland tax history, the Comptroller has attempted to tax a corporation formed for valid business purposes that has no physical presence in the State of Maryland. It is the Respondent's position that this attempt may not proceed by ad hoc adjudication, but rather requires formal rulemaking.

In asserting that the Comptroller must proceed by rulemaking, the Respondent is not requesting that this Court require the State to do anything more than many of its sister states have done. For example, seventeen states have adopted prospective statutes or regulations attempting to deal with finance or intellectual property subsidiaries (statutes have been enacted in Indiana, Iowa, Kentucky, Massachusetts, Minnesota, Pennsylvania, Tennessee, and West Virginia; regulations have been promulgated by Arkansas, Florida, Iowa, Massachusetts, New Jersey, New Mexico, North Carolina, South Carolina [post-*Geoffrey*], and Wisconsin.)

Based upon the clear holding in *CBS*, as well as the Maryland Administrative Procedure Act, the Respondent submits that the Comptroller's attempt to force the Respondent to file Maryland corporate income tax returns without promulgating a formal regulation is both illegal and invalid.

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D. *The Tax Court Did Not Commit Reversible Error in Holding that Penalty Should be Abated.*

As previously discussed, the Comptroller's assessment involves a novel broadening of a narrow and unique case (*Armco*). Moreover, the Respondent reasonably relied on the results of the First Audit (or the lack thereof).

The Respondent's actions were reasonable. Its reliance on the Comptroller's Release was reasonable. In addition, the Respondent acted in good faith at all times in its belief that it was not required to file Maryland corporate income tax returns.

It should be noted that the same auditor, Jeffrey Marks, who was involved in the present Second Audit was also the auditor who was involved in the First Audit covering tax years 1987-91 (which are three of the five tax years *again* involved in the Second Audit). Mr. Marks recommended, with respect to the First Audit, that no penalties be assessed for the reason: "appears T/P made good faith effort to properly file returns." The Respondent's Exhibit 54, Corporation Income Tax Audit Program, Explanation on p. 18. The Comptroller agreed with this recommendation, and no penalties were assessed for those tax years in the First Audit. Exhibit 54, March 1, 1993 Notice of Proposed Audit Adjustments.

Under the circumstances, including the circumstances that the Comptroller's office knew at the time of the First Audit of the Respondent's existence as a Delaware holding company and the amount of its receipts and expenses — and

also knew that *Armco* had been decided — there clearly was substantial evidence underpinning the Tax Court's findings of fact that the Comptroller's failure to waive penalties (and interest) in the Second Audit constituted an abuse of the Comptroller's discretion.

## CONCLUSION

For the foregoing reasons, the Tax Court's Decision should be affirmed, and the Comptroller's appeal denied.

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**APPENDIX J — BRIEF OF APPELLEE DATED OCTOBER 10, 2000**

**IN THE**

**COURT OF APPEALS OF MARYLAND**

SEPTEMBER TERM, 2000

NO. 80

COMPTROLLER OF THE TREASURY,

Appellant,

v.

CROWN CORK & SEAL CO. (DELAWARE), INC.,

Appellee.

Writ of Certiorari to the Court of Special Appeals of Maryland

**BRIEF OF APPELLEE**

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[Tables intentionally omitted]

## QUESTIONS PRESENTED

1. Does the State of Maryland possess sufficient nexus with the Appellee to subject the Appellee to Maryland corporate income tax?

2. May a long-standing policy of the Comptroller, evidenced both by audit acquiescence and a formal release, be changed retroactively and without formal rulemaking?

3. If the Appellee is subject to Maryland corporate income tax, may the apportionment factors of the Appellee's parent be used to determine the Appellee's tax liability?

4. If the Appellee is subject to Maryland corporate income tax, should a penalty be imposed on the Appellee?

*Appendix J*

## STATEMENT OF FACTS

The Appellant has not challenged the Tax Court's factual findings. (Appellant's Brief, 16-17.) Nonetheless, the Appellant's Brief attempts to alter those findings by presenting its own version. Accordingly, the Appellee sets forth below additional facts to correct and expand the Statement of Facts contained in the Appellant's Brief.

### I. *Crown, Cork & Seal Company, Inc.*

Crown, Cork & Seal Company, Inc., a Pennsylvania corporation ("Crown Parent"), is a publicly held corporation engaged in the worldwide manufacturing and sale of metal cans, crowns, and closures for bottles, can filling machines, and plastic bottles and containers. (E. 33.) The company was founded in Baltimore in 1892 and is currently headquartered in Philadelphia. Its stock is traded on the New York Stock Exchange. (E. 582-583.)

In the late 1960's, Crown Parent owned 26 manufacturing plants in the United States and had annual sales of approximately $300 million. (E. 585.) In the late 1980's and early 1990's, Crown Parent embarked upon a period of rapid expansion. This growth spurt was a deliberate reaction to consolidation occurring among Crown Parent's customers. (E. 591-592.)

The strategy of growth and acquisition was successful. In December 1989, Crown Parent acquired one of its major competitors, Continental Can of Canada. (E. 594.) The following year, Crown Parent purchased a metal operation

in the United States. That was followed, in 1991, by the acquisition of a number of foreign and domestic competitors. (E. 594.) In 1996, Crown Parent consummated its largest acquisition. As a result of these acquisitions and internal growth, Crown Parent today has 280 manufacturing plants in 56 countries, and revenue of approximately $9 billion per year. (E. 585-586.)

As Crown Parent embarked upon this aggressive acquisition campaign, it sensed that it was becoming an acquisition target. The late 1980's and early 1990's were marked by frenetic acquisition activity, often hostile to management. In 1989, Crown Parent possessed a balance sheet that was the envy of many publicly held companies. It had no debt. (E. 593.) This made Crown Parent an ideal target for a hostile takeover. This concerned the company's management. (E. 593.)

During the years in issue, Crown Parent owned and operated manufacturing plants in Baltimore City, Harford County, and Wicomico County, Maryland. (E. 33.) Crown Parent timely filed all Maryland corporate income tax returns for the periods in question. (E. 33.)

**II. *Creation of the Appellee.***

The Appellee (Crown Cork & Seal Co. (Delaware), Inc.) was formed principally as a hostile takeover defense. (E. 592-593; 1082.) By Crown Parent contributing its valuable trademarks and patents (collectively, "intellectual property") to a wholly owned, single purpose subsidiary, these valuable assets could be insulated from hostile takeovers and deployed

to prevent them. The testimony of the Appellee's general counsel on this point was not only uncontradicted, it was corroborated twice over.

A. C. Sondhi, Ph. D., an independent investment and financial advisor who has studied finance and intellectual property subsidiaries for over 20 years and who qualified as an expert in the Tax Court, testified that while there are "several reasons" for establishing an intellectual property subsidiary, "probably the most important reason and . . . how it all began to some extent" was as a hostile takeover defense. Dr. Sondhi further testified that "in the event that the company is the object of a hostile takeover they can defend themselves by either selling or otherwise using that valuable asset, the intellectual property, to . . . borrow so much money as to make the takeover untenable to the hostile bidder." (E. 688-689.)

In addition, Arthur Seidel, Esq., an independent intellectual property attorney with over 50 years experience in the field, who qualified as an expert in the Tax Court, testified that "the most common [reason for forming intellectual property subsidiaries] is the anti takeover . . . . You can borrow against it and prevent a takeover by running up a large amount of debt, or you can sell it and get a lot of money into the company." (E. 731.)

It was also envisioned by Crown Parent's senior executives that placing intellectual property in one entity could help control and manage that asset as the Crown corporate family grew by acquisition, as well as provide the base for favorable financing, if needed. (E. 592-593.)

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Before Crown Parent's general counsel and senior executives approved the formation of an intellectual property protection company (an "IPPC"), they sought the advice of independent experts. Crown Parent's general counsel, Richard Krzyzanowski, testified: "We approached law firms. We approached accounting firms. We approached engineering firms. We talked to the outside intellectual property law firms." (E. 593.)

It was only *after* the decision was made to organize an IPPC that Crown Parent, on advice of outside counsel, determined where that entity should be incorporated. (E. 593-594.) Mr. Krzyzanowski also testified that no third party had any arrangement with Crown Parent or the Appellee to be compensated in connection with this transaction as a function of state tax savings. (E. 596.)

Once it was determined that Crown Parent's valuable intellectual property rights would be conveyed to an IPPC, those intellectual property rights were valued by an independent appraiser. That appraisal also determined an appropriate royalty rate for licensing that property. (E. 602.)

Based on the recommendation of outside counsel, the Appellee was formed as a Delaware corporation. (E. 593-594.) Crown Parent contributed all of its valuable domestic intellectual property rights to the Appellee in exchange for all of the Appellee's issued and outstanding stock. All documents necessary and appropriate to create and evidence this transaction were duly prepared. (E. 600-601.)

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After the intellectual property was assigned to the Appellee, the Appellee licensed the right to use those assets to Crown Parent. In exchange for that license, Crown Parent was required to pay a royalty to the Appellee at the rate set forth in the independent appraisal. (E. 600-602.) The royalty was actually paid. (E. 615.) Expert testimony indicated that the royalty rate was "very low." (E. 732.)

At all times during its existence, the Appellee had business cards in the hands of its officers, and signage at its principal place of business in Delaware. (E. 589; 610-614.) In addition, the Appellee maintained an office and bank accounts in Delaware and had employees performing services pursuant to written employment agreements. (E. 607-609; 1082.)

At no time did the Appellee own or lease tangible personal or real property in the State of Maryland. (E. 33.) At no time did the Appellee have employees in the State of Maryland. (E. 33.)

At no time did the Appellee have bank accounts in the State of Maryland. (E. 33.)

It is true, as the Appellant notes repeatedly in its Brief, that the Appellee was an entity with a large amount of income and a small amount of expenses. This, however, does not imply that the Appellee is a "phantom." Dr. Sondhi testified at trial that he has seen many examples of single-purpose subsidiary corporations with large income and small expenses. He mentioned that "Sears Acceptance Corporation is a great example of that. They used to borrow in the open

market about a billion dollars a day. And I think they had less than twenty employees. . . ." (E. 697-698.) It is no wonder that the Appellee, with far less gross receipts, had far fewer employees. However, no one would seriously argue that Sears Acceptance Corporation, one of the largest finance companies in the country, is a "phantom" corporation.

The Appellant also argues in its Brief that there is no evidence that the Appellee was actually used for any business purpose other than protection against a hostile take-over. Again, Dr. Sondhi, with his vast experience in this area, indicated that it is not uncommon for subsidiaries to be organized for a purpose, but for that purpose not to be realized until many years after the date of organization. Dr. Sondhi specifically mentioned subsidiaries organized by IBM and AT&T as examples of subsidiary corporations which were organized for a specific purpose, but which were not used for that purpose for a number of years. (E. 696.)

**III.** ***The First Audit.***

In 1993, the Appellant commenced an audit of Crown Parent for tax years 1989, 1990 and 1991 (the "First Audit"). (E. 770-771.) Jeffrey Marks of the Appellant's office performed the First Audit. (E. 770-771.) Despite the fact that Mr. Marks acknowledged that "the existence and indeed the income and expenses of [the Appellee] are clearly shown on the '89 return" and that the return was "obtained as part of [the] audit" of Crown Parent, no audit was initiated of the Appellee and no assessment was made with respect to the Appellee. (E. 783.)

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There is no question that Crown Parent supplied sufficient information during the First Audit to enable the Appellant to determine the existence of a Delaware IPPC. Mr. Marks testified that the reason no audit of the Appellee was initiated during the First Audit was that "[d]uring the earlier audit I was not aware about the Delaware holding companies. The *Geoffrey* case hadn't come out." (E. 783.) Mr. Marks was asked, "[H]ad you been looking for the existence and for the taxable income and for the expenses of [the Appellee] at the time [of the First Audit], you would have clearly seen these things by virtue of at least the 1989 and 1990 Maryland returns with their attachments?" Mr. Marks answered, "That's correct." (E. 787.)

The Appellee issued a *subpoena duces tecum* to the Appellant to produce his First Audit file at the trial. The Corporation Income Tax Audit Program covering the First Audit is contained in this file. The Program is just what its name denotes, a program describing the steps that an auditor should take during an audit. Step 1.N in the Program requires the auditor to: "Review corporate affiliations and note filing status of related companies in Maryland." (E. 942.) Step 4.E.4 requires the auditor to review: "*Spreadsheet(s)* identifying separate income and expense for each entity of a consolidated group. (i.e.: Income Statement, Balance Sheet for each corporation under review)." (E. 946.) Step 4.E.4 is checked in the box marked "Yes," thereby denoting that Mr. Marks actually reviewed such a spreadsheet. Mr. Marks wrote in the Explanation block for Step 13.B: "Discussed . . . requirement for DISC to file in Md." (E. 957.)

It is clear, therefore, that not only was the information necessary to discern the Appellee's existence available to the Appellant during the First Audit, but the information was actually reviewed by the Appellant's office during the audit.

The notation regarding the DISC requirement is reiterated in a Confidential Narrative dated 10/22/92. On p. 6 of this Narrative, Mr. Marks wrote the following in his hand:

> "Disallowed DISC modif. — DISC does not file in Md.
>
> DISC required to file in Md based on Court case [the 1990 *Armco* decision].
>
> Revised Corp. Income Tax Computation for 1989 & 1991 — T/P did not."

(E. 937.)

It is also abundantly clear, therefore, that the auditor was well aware of the *Armco* decision at the time of his audit of the 1989-91 tax years and indeed disallowed Crown's income tax computation in order to require its DISC income to be included. As will be seen below, the *Armco* case is the linchpin upon which the Appellant rests his theory that the Appellee is subject to taxation in Maryland because it was a phantom.

In other words, both the facts and the law upon which the Appellant now relies to tax the Appellee were known to the auditor at the time of the First Audit.

Nevertheless, the First Audit resulted in no adjustment to the income of Crown Parent or to the Appellee as a result of the Appellee's disclosed existence as a Delaware IPPC.

**IV. *The Second Audit.***

Two years after the First Audit, Mr. Marks was again assigned to audit the Maryland income tax returns of Crown Parent. At this time, Mr. Marks indicated that he "was aware of holding company cases like the *Geoffrey* case in literature and accounting journals." (E. 763.) Mr. Marks testified that he reviewed "the consolidated federal return carefully and saw what appeared to be a Delaware holding company." (E. 763-764.) Despite the fact that the Appellee had existed for all of the years examined in the First Audit, the appearance of a Delaware IPPC now precipitated an audit of the Appellee for its *entire* existence (tax years 1989, 1990, 1991, 1992 and 1993), which included the three years previously audited.

The audit of the Appellee was perfunctory at best. Mr. Marks initially testified that he visited the Appellee's office in Delaware, surely a significant endeavor when determining whether a taxpayer is a phantom. (E. 765.) When confronted with the actual location of the Appellee's Delaware office, however, Mr. Marks admitted that he must have been mistaken in thinking that he visited the Appellee's office, and testified that he must have been "at a different building" on the other side of 1-95. (E. 799-801.)

Further, Mr. Marks testified that he did not ask to meet with George Warren, the individual responsible for the day-to-day operation of the Appellee's business in Delaware.

(E. 802.) Mr. Marks also testified that he never asked to visit the Appellee's offices in Delaware to review its records and files. (E. 802:)

## V. *The Appellant's "Phantom" Culture.*

Perhaps of equal — or greater — importance than the Second Audit was the decision by the Appellant's office in 1995 to audit and assess every Delaware IPPC that crossed its path.

Patrick White came to the Appellant's office in October, 1993, as a hearing officer/tax consultant. He was promoted to a staff legal advisor position in 1995, with a specialty in corporate income taxation. (E. 809-810.)

The Appellant's office became interested in Delaware holding companies in mid-1995 immediately after Mr. White became a staff legal advisor. Two events were important in the "evolution" of the Appellant's position with respect to these companies. (E. 812.)

First, the *Geoffrey* case was decided in South Carolina in 1993 and "precipitated a whole lot of interest . . . from audit departments around the country, inclusive of Maryland, as to what the Delaware holding companies were all about." (E. 812.)

Second, Mr. White attended a seminar in Georgetown in May of 1995 which he testified was a "watershed event, from my standpoint at least, in getting an understanding of how some of these companies could be set up in Delaware very

inexpensively and still book tremendous amounts of income." (E. 813.) Mr. White went to the lobby during an intermission and saw business service providers offering information and brochures for an "office in a box." (E. 814.) These vendors were also advising that Delaware holding companies of this type had never failed on audit before. (E. 814.) Although the Appellant's office did not then "know a lot" about IPPCs or finance companies, Mr. White proceeded to do legal research with respect to intellectual property law and to examine the IPPCs' trademarks and patents and the manner in which they had been acquired and licensed back to their parent or affiliated companies. Mr. White was also involved in attempting to review the books and records of the audited companies from an accounting standpoint. (E. 815-817.)

According to Jeffrey Marks' testimony, Mr. White then proceeded to implement his thoughts with respect to these "phantom companies." Mr. White instructed the auditors how to audit these companies, even though there had not been any previous case dealing with such a company, nor any statute, rule or regulation passed with respect to them, nor any earlier audit history with respect to them. In addition to personally instructing and working with the auditors on the audits of the IPPCs, Mr. White prepared a written narrative for the auditors to use during their audits. The narrative consisted of a series of questions regarding factors and characteristics to look for. (E. 788-789.) The Appellant's office in due course prepared and adopted a "Potential Phantom Companies Checklist" which set forth 18 criteria or factors to be investigated in auditing an IPPC. Blanks were present on the form for information to be filled in by the auditor. (E. 962.) Mr. Marks testified that the criteria set forth

on the Potential Phantom Companies Checklist "essentially codified and put in writing those factors and criteria which [we were] looking for when [we] audited Crown, Delaware in 1995 and 1996." These criteria "formalized" the Appellant's policy and procedures. (E. 790-793.)

In addition to working with the auditors and preparing the narrative, which in turn gave rise to the Potential Phantom Companies Checklist, Mr. White also conducted training sessions for the auditors where he discussed the factors and criteria for an IPPC audit. (E. 789.) Mr. White, according to his own testimony, also worked closely with the hearing officers involved in these cases, suggesting to them what documents and evidence they should require and review and actually writing the intellectual property portions of their opinions for them, as he did in this case. (E. 816-817; 916-917.)

A distinctive lexicon was developed by the Appellant's office with respect to these IPPCs. Mr. Marks testified they were often called "shell companies" or "bookkeeping entities." (E. 796.) They were also sometimes referred to as "tax havens." (E. 797.) Mr. White's own testimony is replete with examples of this vocabulary.

In summary, the Appellant's office starting in 1995 prepared its own private regulations with respect to IPPCs. While there have been at least 50-100 IPPC audits since then, virtually none of the companies have escaped the inevitable assessment resulting from the Appellant's private (and unpublished) regulations. (E. 926-928.)

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**VI. *The Decisions Below*.**

The Maryland Tax Court reversed the assessments imposed on the Appellee by the Appellant. The Tax Court found, as a matter of fact, based on the testimony and evidence presented at trial, that the Appellee "does not own or lease property in Maryland. [The Appellee] has no employees, agents, or offices in Maryland. Its income producing activity all occurs outside of Maryland. Crown Parent is the only contact [the Appellee] has with Maryland. . . ." (E. 1082.) Accordingly, the Tax Court held that the Appellee itself had insufficient contacts with the State of Maryland to create the "substantial nexus" necessary for this tax to comport with the dictates of the Commerce Clause of the U.S. Constitution.

The Tax Court then considered whether the nexus of Crown Parent could be attributed to the Appellee. The Tax Court ruled that, under Maryland law, nexus is attributed from one entity to another "only when the entities were true phantom corporations." (E. 1082.) The Tax Court then found as a matter of fact, based on the evidence and testimony presented at trial, that "the evidence presented clearly shows that [the Appellee] is not a phantom or sham corporation. [The Appellee] is a viable entity established for valid business purposes, including the protection of valuable intellectual property rights from hostile take-overs of the parent corporation. [The Appellee] maintained an office in Delaware, met all corporate formalities, had separate bank accounts and employees performing services pursuant to written employment agreements. In addition, [the Appellee] received royalty income from third parties (other than Crown

Parent or an affiliate) during some of the years in controversy." (E. 1082.)

In its decision in *SYL, Inc. v. Comptroller, (M.T.C No. 96-0154-01 1999)*,[1] which the Tax Court "incorporated by reference to the resolution of the legal issues presented" in this case (E. 1081-1082), the Tax Court stated that "having found that the requisite nexus to warrant the imposition of income tax does not exist, the issue of whether a regulation had to be promulgated becomes moot. However, due to the number of taxpayers involved and the likelihood of judicial review, we shall address the issue." Appellant's Brief, App. 16. With respect to this issue, the Tax Court held that "the [Appellant's] attempt to assert tax against non-nexus, non-phantom trademark protection companies as a result of their licensing of the use of their trademarks, trade names and service marks to entities which had nexus with the State amounts to a substantially new or change in policy which can only be instituted through rulemaking procedures." *Id.*

The Circuit Court for Baltimore City, through Judge Joseph H. H. Kaplan, held that "this Court agrees with the Maryland Tax Court on the issue of nexus. . . ." (E. 1098.) The Circuit Court "held that the Maryland Tax Court recognized and applied the correct principles of law governing the Crown Delaware case." (E. 1099.) In addition, the Circuit Court held ". . . that the Maryland Tax Court's factual findings were supported by substantial evidence in the Crown Delaware case in reference to the nexus issue." (E. 1099.) Finally, the Circuit Court stated that it "has given the Maryland Tax Court great deference and holds that a

1. The *SYL* decision is printed in Appellant's Brief, App. 9-18.

reasoning mind could reasonably have reached the conclusion reached by the Maryland Tax Court in the Crown Delaware case in that there was no nexus between [the Appellee] and the State of Maryland." (E. 1099.)

With respect to the Tax Court's finding that the Appellant was required to promulgate a regulation before assessing the Appellee, the Circuit Court stated that "this Court agrees with the Maryland Tax Court's holding that the [Appellant's] attempt to assert tax on [the Appellee] amounted to a substantially new or change in policy and therefore can only be instituted through rulemaking procedures as required by law, which makes the [Appellant's] attempt improper." (E. 1100.)

The Circuit Court found that "prior to 1995, companies such as [the Appellee] were not subject to tax, however, phantom companies like those found in *Armco* and *Atlantic Supply* were subject to tax. The [Appellant] relied on ADR No. 2 . . . to set forth parameters of taxing foreign corporations." (E. 1101.) The Circuit Court went on to say that "this Court agrees with the Maryland Tax Court on the issue of whether the [Appellant's] assessment amounts to a substantially new or change in policy which can only be instituted through the rulemaking procedure pursuant to *CBS, Inc.* and the Maryland Administrative Procedures Act." (E. 1103.)

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## SUMMARY OF ARGUMENT

To validly impose an income tax on the Appellee, it is necessary for the Appellant to show that "substantial nexus" exists between the State of Maryland and the Appellee. The existence of nexus is a factual matter. Accordingly, it is not surprising that the Appellant chooses to ignore the Tax Court's numerous findings of fact, made after two days of trial and the testimony of half a dozen witnesses.

For example, the Appellant states, as if it were a finding of fact in the Tax Court, "that [the Appellee] . . . was a paper entity, lacking substance of its own, and entirely dependent on its operating affiliate to earn its income." (Appellant's Brief, 28.) In fact, the Tax Court found that the Appellee "is a viable entity established for valid business purposes . . . maintained an office in Delaware, met all corporate formalities, had separate bank accounts and employees performing services pursuant to written employment agreements. In addition, [the Appellee] received royalty income from third parties . . . during some of the years in controversy." (E. 1082.)

The Appellant has conceded the correctness of the Tax Court's factual findings, expressly limiting its arguments on appeal to the correctness of the Tax Court's legal conclusions. (Appellants Brief, 16-17.) But the Tax Court's factual conclusions in this case not only support its legal conclusions, they mandate them. For example, the U.S. Constitution prohibits States from imposing an income tax upon an entity unless it is shown, as a matter of fact, that "substantial nexus" exists between the State and the entity. The Appellant asserts

that the Tax Court erred in applying this legal principle to the Appellee. But the Tax Court's unchallenged factual finding that there was no substantial nexus between the Appellee and Maryland is fatal to the Appellant's argument. Similarly, the Court of Special Appeals has ruled that a "sham" or "phantom" entity may be treated as the alter ego of an entity subject to Maryland tax for purposes of taxation. The Appellant contends that the Tax Court misapplied this legal principle. But the Tax Court's factual finding that the Appellee is not a "phantom" entity is fatal to this argument, as well.

Put simply, the facts are as they were found by the Tax Court. They are not subject to being re-litigated *de novo* on appeal. These facts make it clear that the State of Maryland lacks substantial nexus with the Appellee, and that the Appellee is not a "phantom."

The Appellant's assertion that corporations like the Appellee can have substantial nexus with a taxing state notwithstanding their lack of physical presence in that state is mainly predicated on *Geoffrey, Inc. v. South Carolina Tax Commission, 437 SE.2d 13 (S.C. 1993), cert. denied, 510 U.S. 772 (1993).* The Appellee will show that this decision is not only contrary to the Supreme Court's most recent pronouncement on the requirement of substantial nexus for state tax purposes, but has been repudiated by most of the states that have had the opportunity to review it.

Desperately seeking another means to create nexus where there is none, the Appellant attempts to attribute to the Appellee the substantial nexus that admittedly exists between

Crown Parent and the Appellant. The Appellee will show that this attempt to attribute nexus is based on: (i) a gross misunderstanding of the role "unitarity" plays in nexus determinations, (ii) a tortured interpretation of the holding in *Comptroller v. Armco Export Corporation, 82 Md. App. 429, cert. denied, 320 Md. 634 (1990), cert. denied, 498 U.S. 1088 (1991)*, and (iii) facts that exist only in the mind of the Appellant, and not in the decision of the Tax Court.

Finally, it is the Appellee's position that, in any event, the drastic change of position evidenced by the Appellant's theory of this case, in concert with its application to literally hundreds of corporations, may not be accomplished retroactively by adjudication, but only prospectively by rulemaking.

## ARGUMENT

### I. THE STANDARDS FOR JUDICIAL REVIEW OF TAX COURT DECISIONS

An appeal from a final order of the Maryland Tax Court is governed by the provisions of §§10-222 and 10-223 of the State Government Article. See §13-532(a)(1) of the Tax General Article.

A reviewing court's review of a final order of the Tax Court is limited. *Ramsay, Scarlet & Co., Inc. v. Comptroller, 302 Md. 825, 834-835 (1985)*; *Comptroller v. Diebold, Inc., 279 Md. 401, 407-408 (1977)*. The court is required to affirm the Tax Court's decision unless the court determines that the Tax Court was erroneous as a matter of law, or that the Tax

Court's decision was not supported by substantial evidence. *Comptroller v. Washington National Area Limited Partnership, 66 Md. App. 416, 425-427 (1986).*

In *United Parcel Service, Inc. v. Comptroller, 69 Md. App. 458, 464-465 (1986)*, the Maryland Court of Special Appeals, elaborating on the principles set forth in *Ramsay, Scarlett*, set forth the following three-step analysis for review of a Tax Court decision:

> 1. First, the reviewing court must determine whether the agency recognized and applied the correct principles of law governing the case. The reviewing court is not constrained to affirm the agency where its order "is premised solely upon an erroneous conclusion of law."
>
> 2. Once it is determined that the agency did not err in its determination or interpretation of the applicable law, the reviewing court next examines the agency's factual findings to determine if they are supported by substantial evidence, i.e., by such relevant evidence as a reasonable mind might accept as adequate to support a conclusion. ". . . . it is the agency's province to resolve conflicting evidence, and, where inconsistent inferences can be drawn from the same evidence, it is for the agency to draw the inference."
>
> 3. Finally, the reviewing court must examine how the agency applied the law to the facts. This, of course, is a judgmental process involving

> a mixed question of law and fact, and great deference must be accorded to the agency. The test of appellate review of this function is "whether, . . . a reasoning mind could reasonably have reached the conclusion reached by the [agency], consistent with a- proper application of the [controlling legal principles [Citations omitted.]

In the Circuit Court, Judge Kaplan in his Memorandum Opinion carefully applied the three-step test enunciated in *United Parcel* and concluded that the Tax Court had correctly applied the applicable law and that there was substantial evidence supporting the Tax Court's decision. The Circuit Court, accordingly, armed the Tax Court.

This brief will demonstrate that the Tax Court recognized and applied correct principles of law to this case and that the Tax Court's findings of fact were supported by substantial evidence, as the Circuit Court found. Indeed, it would be difficult for any "reasoning mind" to reach any other conclusions that those reached by the Tax Court.

The test for review by this Court is the same as that used by the Circuit Court. *Ramsay, Scarlett, supra*; *Diebold, supra.* This Court's review therefore involves the same analysis which was set forth in *United Parcel* and which was applied by Judge Kaplan.

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## II. NEXUS SUFFICIENT TO SUBJECT THE APPELLEE TO CORPORATE INCOME TAX DOES NOT EXIST BETWEEN THE APPELLEE AND THE STATE

### A. *The Appellee Lacks Actual Nexus with the State of Maryland.*

#### 1. *Overview.*

The Tax Court and the Circuit Court both found that under relevant U.S. Supreme Court decisions, the Appellee must possess "substantial nexus" with the State of Maryland for the imposition of a corporate income tax by the State of Maryland to pass muster under the Commerce Clause of the U.S. Constitution. As will be shown below, the Appellee does not possess any connection with the State that could suffice to constitute "substantial nexus" even under the most liberal interpretation of that phrase.

#### 2. *Unitarity is a "Red Herring."*

In its Brief, the Appellant makes much ado about the concept of "unitarity," and the fact that the Appellee is part of a unitary group of corporations. It appears that the Appellant believes that if one member of a unitary group has substantial nexus with a state, then all members of that group have substantial nexus with that state (even members with no physical presence in that state). Indeed, Appellant asserts: "The presence of the unitary relationship between Crown Delaware and [the Appellee], in conjunction with Crown Parent's acknowledged and significant presence in

Maryland, establishes the authority of Maryland to tax [the Appellee]. . . ." (Appellant's Brief, 19.)

It is hard to overstate what a perversion of the concept of unitarity this theory represents. No court has ever held that establishing nexus with one member of a unitary group suffices to establish nexus with all members of that group. The cases cited by the Appellant as standing for this proposition state nothing remotely close.

The Tax Court properly debunked this theory when it stated in the *SYL* decision that "the unitary relationship between entities does not automatically establish nexus on all of the corporate entities in the unitary group. . . .' The mere presence of an in-state affiliate of a unitary group does not confer nexus on a non-phantom out-of-state affiliate of the same group [citation omitted]. In the unitary taxation scheme, the foreign corporation's income and factors may be included in determining the tax liability of the in-state affiliate. However, without nexus, the foreign corporation does not become subject to the taxing jurisdiction.'" *SYL* decision, Appellant's Brief, App. 15.

The cases cited by the Appellant as holding that unitarity is a sufficient condition to impose income tax on all members of the unitary group, hold nothing of the kind and are easily distinguishable from this case. For example, the Appellant relies on *Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959)*, for the proposition that the U.S. Supreme Court has held that "affiliated companies can act through others and are taxable when they do." (Appellant's Brief, 14.) However, *Northwestern* differs

factually from this case in a significant way. In *Northwestern*, both of the corporations in the unitary group had physical presence in the state imposing the tax. Far from holding that merely being part of a unitary group automatically subjects all members of the group to tax, the Supreme Court, in *Northwestern*, stated expressly that the physical presence in the taxing state of both corporations was a major factor in finding the tax Constitutional. *Northwestern* at 465.

The Comptroller also cites *Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980)*, for the proposition that "The presence of the unitary relationship between [the Appellee] and Crown Parent in conjunction with Crown Parent's acknowledged and significant presence in Maryland, established the authority of Maryland to tax [the Appellee]." (Appellant's Brief, 19.) To cite *Mobil* to justify taxing the Appellee is to look at the *Mobil* decision through the wrong end of the telescope. *Mobil* involved the question of whether a unitary group member with admitted physical presence in Vermont could be taxed on a portion of the dividends it received from out of state (but unitary) subsidiaries. In other words, to properly apply *Mobil* to this case is to ask whether the State of Maryland may impose an income tax on Crown Parent as a result of dividends received from the Appellee. *Mobil* is of no relevance whatsoever to the question of whether a state may impose an income tax on a corporation with no physical presence in that state.

Notwithstanding the existence of a unitary group of corporations, a state's ability to tax members of the group is *always* subject to the dictates of the Due Process Clause and the Commerce Clause of the U.S. Constitution.

*Appendix J*

3. *The Due Process Clause.*

In *Shaffer v. Carter, 252 U.S. 37 (1920)*, the Supreme Court held that the imposition of tax on a non-resident taxpayer was a valid exercise of a state's taxing power. The court determined that the Due Process requirements of the U.S. Constitution were satisfied since the taxpayer's property, from which the income to be taxed was derived, received the benefits conferred and protections afforded by the laws of the taxing state.

The Supreme Court's decision in *Shaffer* established a standard of fairness in state taxation that continues today. That standard suggests that if there is a sufficient connection between the taxing state and the non-resident taxpayer, and the tax imposed is fairly related to the non-resident taxpayer's in-state activities, the tax will be upheld under the Due Process Clause.

4. *The Commerce Clause.*

The Commerce Clause of the U.S. Constitution prohibits states from unduly burdening interstate commerce. In 1977, the Supreme Court held that states were not barred from imposing a non-discriminatory tax upon the privilege of engaging in interstate commerce. In that case, *Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977)*, the Supreme Court introduced a four factor test for Constitutionality under the Commerce Clause to which it still adheres. Under this test, a state tax will pass Constitutional muster under the Commerce Clause if it: (i) is fairly apportioned; (ii) is applied to an activity that has substantial nexus with the taxing state;

(iii) does not discriminate against interstate commerce; and (iv) is fairly related to the services provided by the taxing state.

a. *Quill.* In *Quill Corp. v. North Dakota, 504 U.S. 298 (1992)*, the Supreme Court provided its most extensive discussion of the Constitutional limits of state taxation. In *Quill*, the Supreme Court held that an out-of-state mail-order vendor with no physical presence in the taxing state, which merely mailed catalogs into that state and filled orders by U.S. Mail and common carrier, was protected by the Commerce Clause from the imposition of a use tax collection responsibility in that state.

In reversing the North Dakota Supreme Court's decision, the U.S. Supreme Court held that the nexus requirements imposed by the Due Process Clause and the Commerce Clause "pose distinct limits on the taxing powers of the States." *Id.* at 305. With respect to the Due Process Clause, *Quill* stated that physical presence was not required. Rather, the Court ruled that "if a foreign corporation purposefully avails itself of the benefits of an economic market" or purposefully directs its "efforts toward the residents of another state," and if subjecting the corporation to the state's tax and jurisdiction does not offend "traditional notions of substantial justice," then nexus sufficient to satisfy the Due Process Clause exists. *Id.* at 307.

However, the Supreme Court stated that a different standard must be applied under the Commerce Clause. In the Supreme Court's view, the Due Process Clause and the Commerce Clause were "animated by different

constitutional concerns and policies." The Court found that "substantial nexus" was required under the Commerce Clause, and that substantial nexus required more than the "minimum contacts" necessary to satisfy the Due Process Clause. **At least in the context of a use tax collection responsibility, the Supreme Court held that the Commerce Clause's "substantial nexus" standard required physical presence in the taxing state.**

Although *Quill* involved the Constitutionality of a use tax collection responsibility, the Appellee submits that there is no substantive Constitutional difference between a use tax and a net income tax. In fact, fairness may dictate that the level of contacts required for a state to impose an obligation to merely collect a use tax from a customer is lower than the level of contacts required to impose a direct income tax on a corporation.

Despite the Appellant's protestations to the contrary, the Supreme Court's analysis of nexus requirements under the Due Process and Commerce Clauses in *Quill* was not limited to a use tax. The Supreme Court implicitly made this point when it stated, "although we have not, in our review of other types of taxes, articulated the same physical-presence requirement . . . established for sales and use taxes, that silence does not imply repudiation of [these rules]." *Id.* at 314. In fact, the Supreme Court expressly noted that in all of its prior cases upholding taxation against Commerce Clause challenge, the taxpayer had physical presence in the taxing state. *Id.* at 314.

In addition, the Supreme Court noted that it had cited with approval the physical presence requirement in cases involving taxes other than use tax collection. *Quill* at 311. See for example, *Goldberg v. Sweet, 488 U.S. 252 (1989)* (telecommunications excise tax); *Commonwealth Edison Co. v. Montana, 453 U.S. 609 (1981)* (severance tax); *Mobil Oil Corp., 445 U.S. 425 (1980)* (corporate income tax).

b. *Geoffrey*. The Appellant argues that permitting one's intellectual property to be used in a state is sufficient to establish substantial nexus with that state under the Commerce Clause. In this argument, the Appellant relies on *Geoffrey Inc. v. South Carolina Tax Commission, 437 SE.2d 13 (S.C. 1993), cert. denied, 510 U.S. 992 (1993)*, a case in which the South Carolina Supreme Court held that licensing an intangible asset in South Carolina constituted "substantial nexus" under the U.S. Constitution.

*Geoffrey's* Commerce Clause analysis is, at best, problematic. After citing the four factor (*Complete Auto Transit*) test, the South Carolina Supreme Court completely ignored the Commerce Clause issues discussed in *Quill.*

The South Carolina Supreme Court gave no indication that it even recognized the real Commerce Clause issue before it. The court did not consider whether the concerns that lead to the Supreme Court's reaffirmation of the physical presence test for use tax collection in *Quill* were equally applicable to an income tax. In addition, the South Carolina Supreme Court failed to perform the careful weighing of issues and balancing of interests that the Supreme Court in *Quill* clearly called for in all Commerce Clause challenges to state taxation.

In fact, *Geoffrey* appears to have assumed that nexus sufficient for the Due Process Clause (i.e., purposefully availing itself of the benefits of an economic market) is nexus sufficient for the Commerce Clause. If there is one undisputed lesson from *Quill*, it is that such an assumption is absolutely wrong (". . . a corporation may have the 'minimum contacts' with a taxing state as required by the Due Process Clause, and yet lack the 'substantial nexus' with that State as required by the Commerce Clause"). *Quill* at 313.

*Geoffrey's* cavalier treatment of the Commerce Clause has been either rejected or ignored by the reported decisions of courts of the jurisdictions that have had the opportunity to analyze it.

In *J.C. Penney National Bank v. Johnson, 19 S. W. 3d 831 (Tenn. 1999)*, Tennessee's Court of Appeals ignored *Geoffrey* in analyzing whether a bank possessed the requisite contacts with the state to justify the imposition of a franchise tax. The court, following *Quill*, distinguished between nexus sufficient for the Due Process Clause and nexus sufficient for the Commerce Clause (as *Geoffrey* failed to do), and held that the bank lacked substantial nexus under the Commerce Clause because the bank had no physical presence in the state. It is important to bear in mind that the Court of Appeals of Tennessee failed to find nexus despite the fact that the tax involved was not a sales or use tax, and despite the fact that the bank's parent company had physical presence in the state. In fact, the court expressly found that *Quill's* physical presence requirement was not limited to sales and use tax cases ("While it is true that the *Bellas Hess* and *Quill* decisions focused on use taxes, we find no basis for

concluding that the analysis should be different in the present case . . .". *Id.* at 839.

More recently, in *Rylander v. Bandag Licensing Corporation, 18 S. W. 3d 296 (Tex. App. 2000)*, the Texas Court of Appeals also held that the physical presence test set forth in *Quill* was not limited to sales and use taxes. As a result, the *Rylander* court held that the State of Texas could not impose a franchise tax on a corporation that lacked physical presence in the State of Texas. While the *Rylander* court noted that the *Quill* decision involved a sales and use tax, it went on to state that it saw "no principled distinction when the basic issue remains whether the state can tax the corporation under the Commerce Clause . . . when a corporation . . . lacks any physical presence in the state, no sufficient nexus exists to permit the state to assess tax." *Id.* at 300.[2]

In support of its position that physical presence is not required to create "substantial nexus" under the Commerce Clause, the Appellant fails to cite any case other than *Geoffrey* that truly stands for that proposition. For example, the Appellant cites *Couchot v. State Lottery Commission, 659 N.E. 2d 1225 (Ohio 1996), cert. denied, 519 U.S. 810 (1996)*, as standing for the proposition that *Quill* does not extend to "cases involving taxation measured by income derived from the state." (Appellant's Brief, 22.) *Couchot* is a strange case to cite for the position that physical presence in the taxing

2. It bears noting that in at least the States of Alabama, Georgia, and New York, unreported administrative decisions have refused to follow *Geoffrey*. In light of Md. Rule 8-114, the Appellee has not included citations to these decisions.

state is not required for the imposition of an income tax. *Couchot* involved the question of whether a non-Ohio resident could be subject to Ohio income tax on his Ohio lottery winnings. Far from holding that this lucky individual's physical presence in Ohio was irrelevant to finding nexus, the court expressly found that Mr. Couchot both purchased and redeemed his winning lottery ticket in the state of Ohio. *Couchot* at 1230. In other words, there was no question that the taxpayer had physical presence in the taxing state.

**B. *The Appellee lacks "attributed" nexus with the State of Maryland.***

Having failed to establish that actual nexus exists between the Appellee and the State of Maryland, the Appellant attempts to attribute to the Appellee the substantial nexus that unarguably exists between the State of Maryland and the Appellee's parent, Crown Parent. For a number of reasons, the Tax Court held that it was inappropriate to attribute the nexus that exists between the State of Maryland and Crown Parent to the Appellee.

1. *The Appellant's Attempt to Expand Comptroller v. Armco.*

The only reported Maryland decision holding that a so-called "phantom" or "bookkeeping entity" can acquire Maryland nexus solely because of the presence of a unitary affiliate is *Comptroller v. Armco Export Sales Corp., 82 Md. App. 429 (1990), cert. denied, 498 U.S. 1088 (1991).* In essence, the Tax Court found that the Appellant's attempt to apply *Armco* to the case at hand represented a substantial

expansion of a narrowly drawn doctrine that did not even exist until *after* the Appellee was organized.

*Armco* dealt with the State's ability to tax domestic international sales corporations ("DISCs"). A DISC is strictly a creature of the Internal Revenue Code. As stated in *Armco*, a DISC "is a phantom bookkeeping entity corporation created under the federal tax law as a device to encourage exports through an exemption from otherwise taxable profits." *Armco* at 430.

The Internal Revenue Service (the "IRS") recognizes that DISCs are corporations without substance that receive special treatment by dint of federal legislation. See U.S. Income Tax Regulations Sec. 1.992-1(a) (". . . the rules contained in this paragraph [regarding DISCs] constitute a relaxation of the general rules of corporate substance otherwise applicable under the [Internal Revenue] Code"). The pertinent provisions of this Regulation are attached as Appendix A. In other words, but for a legislative mandate, the IRS would not recognize DISCs as entities for income tax purposes.[3]

The DISCs at issue in *Armco* had *no* employees, owned no property, and were *entirely dependent* on their parent corporations for income. In addition, the DISCs served no conceivable business purpose other than securing Federal income tax benefits. Finally, and perhaps most importantly, in subjecting DISCs to Maryland income tax, the *Armco* court

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3. Appellee's counsel are not aware of any reported (or unreported) where the IRS has ever questioned the substance or existence of a Delaware IPPC.

noted a clearly expressed "legislative intent to tax DISCs" since the Maryland General Assembly had enacted a statute expressly subjecting them to Maryland income tax. *Armco* at 437, citing Annotated Code of Maryland, Article 81, Section 280A(c)(7) (under prior income tax law), which was added in 1978.

None of these factors applies to the Appellee. Unlike the DISCs in *Armco*, the Tax Court found that the Appellee was "established for valid business purposes, including the protection of valuable intellectual property rights from hostile takeovers of the parent corporation." (E. 1082.) Unlike the DISCs in *Armco*, the Tax Court found that the Appellee had physical presence (through a leased office) in the State of Delaware, "had separate bank accounts and employees performing services pursuant to written employment agreements" (E. 1082), and "received royalty income from third parties (other than Crown or an affiliate) during some of the years in controversy." (E. 1082.) Finally, there has been no expression of legislative intent to tax IPPCs. In fact, in its 1998 session, the General Assembly declined to even vote on proposed legislation that would have subjected IPPC's to Maryland income tax. See House Bill 682, "Income Tax Out-of-State Holding Companies Doing Business in Maryland," introduced on February 14, 1998, and withdrawn on March 16, 1998.

It is hard to imagine two corporations more different than the DISCs in *Armco* and the Appellee.

In short, the Tax Court found that *Armco* "only applies to entities with no substance whatsoever." *SYL* decision,

printed in Appellant's Brief, App. 13. Based on the facts presented at trial, the Tax Court found that the Appellee had substance and that *Armco* could, therefore, not be used to attribute nexus to the Appellee. The factual findings made by the Tax Court are supported by substantial (and largely uncontradicted) evidence and present no grounds for reversal.

2. *The Appellant's Interpretation of Armco is Legally Incorrect.*

The Appellant takes the view that for purposes of finding a lack of "substantial economic substance" under *Armco*, the business reasons for establishing a corporation are irrelevant. Patrick White testified: "business reasons are not relevant to our approach. * * * What the reasons were for setting it up doesn't really matter." (E. 914.)

Under an *Armco* analysis nothing should be more germane to the finding of a "phantom" corporation than its business purpose for existing. The language used by the Court of Special Appeals to describe the DISCs in *Armco* is replete with implications that these DISCs had no conceivable non-tax business reason for existing.

The Tax Court found that the uncontradicted evidence in this case showed that the Appellee was formed for valid non-tax business reasons. (E. 1082.) The principal reason was to deter a hostile takeover. Further business reasons for the organization of the Appellee were discussed and demonstrated in the testimony of Mr. Krzyzanowski, Dr. Sondhi and Mr. Seidel and are set forth in the Memorandum Opinion of the Circuit Court. (E. 1094.)

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3. *Holdings in Other States.*

In *SFA Folio Collections, Inc. v. Tracey, 652 N.E.2d 693 (Ohio 1995)*, the Ohio Supreme Court held that the nexus of a taxpayer's in-state affiliate could not be attributed to a taxpayer that had no presence of its own in the taxing state. The same holding, involving the same taxpayer, was made by Connecticut. *SFA Folio Collections, Inc. v. Bannon, 585 A.2d 666 (Conn. 1991), cert. denied, 501 U.S. 1223 (1991)*

Similarly, in *Bloomingdale's By Mail, Ltd. v. Pennsylvania, 130 Pa. Cmwlth 190, 567 A.2d 773, aff'd per curiam, 591 A.2d 1047, cert. denied, 504 U.S. 955 (1992)*, an attempt by the state of Pennsylvania to attribute the nexus of an in-state corporation to an out-of-state affiliate, with no contacts in the Pennsylvania, was rejected.[4]

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4. The Appellant in a footnote cites *Sherwin-Williams Co. v. Commissioner of Revenue, 2000 WL 1005799 (Mass. App. Tax Bd.* 2000), as supporting a contrary position. Appellant's Brief, 21, fn. 7. *Sherwin Williams* is, however, completely distinguishable and is not on point. The Massachusetts Tax Board was there involved in the assessment of a parent corporation, not a subsidiary, based upon statutory reallocation powers given to the Massachusetts Commissioner similar to those contained in IRC§482. This Court expressly held in *Comptroller v. Gannett, 356 Md. 699 (1999)*, that the Maryland Comptroller had no such powers. Moreover, Patrick White testified that the Appellant is not attempting to exercise any such powers as to the Appellee or other IPPCs ("we could not treat them as sham or shell transactions.") (E. 910.)

## III. THE APPELLANT WAS REQUIRED TO PROCEED IN THIS CASE VIA PROSPECTIVE RULEMAKING, NOT RETROACTIVE ADJUDICATION.

A. *Background.*

The Tax Court held that even if the Appellee possessed substantial nexus with the State of Maryland, the Appellant's assessment was invalid for want of rulemaking. The Circuit Court addressed the reason for such an alternate holding, stating: "[H]aving agreed with the Maryland Tax Court's fmding that the requisite nexus to warrant the imposition of income tax on [the Appellee] does not exist, the issue of whether a regulation had to be promulgated becomes moot. However, due to the number of taxpayers involved and the likelihood of judicial review, the Maryland Tax Court addressed this issue and this Court shall do so as well and in greater detail." (E. 1102.)

The Circuit Court concluded that "the [Appellant's] attempt to assert tax on [Appellee] amounted to a substantially new or change in policy and therefore, can only be instituted through rulemaking procedures. . . ." (E. 1100.) In support of this holding, the Circuit Court cited *CBS, Inc. v. Comptroller.*

**B. *CBS.***

In *CBS Inc. v. Comptroller, 319 Md. 687 (1990)*, this Court held that the Appellant may enact certain tax policies only prospectively, and then only by formal rulemaking.

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*CBS* dealt with the manner in which the Appellant apportioned advertising receipts of national broadcasting companies. For a number of years, CBS computed its Maryland income tax pursuant to the three-factor formula. *CBS* at 688. The taxpayer and the Appellant stipulated that the taxpayer's method of apportionment "was reviewed during the audits of prior years . . . and no adjustment . . . was ever proposed." *CBS* at 690. Despite this prior history of acquiescence in the taxpayer's method of apportionment, "when the 1980 and 1981 returns were audited, the Appellant for the first time insisted on the application" of a new apportionment method. *CBS* at 690. The question presented was whether the Appellant's new policy required formal rulemaking.

This Court found that "the effect of the Appellant's audit was to announce a substantially new generally applicable policy with respect to apportionment of the network advertising income of national broadcasting corporations." *CBS* at 699.

This Court explicitly rejected the Appellant's assertion that the authority granted the Appellant in Tax General Article § 10-402(d) gave the Appellant the authority to enact this new policy without formal rulemaking. Quoting *Metromedia, Inc. v. Director, Div. of Taxation, 478 A.2d 742 (N.J. 1984)*, this Court stated "it does not follow that, because [an agency] has statutory discretion, the manner in which this discretion is exercised is not governed by the standards that, determine whether rulemaking or adjudication must be followed in a given case." *CBS* at 698.

This Court held that the Appellant's new policy could not be effected through *ad hoc* adjudication, but only pursuant to the formal rulemaking procedures of the Maryland Administrative Procedure Act. As a result, the Appellant's position could not be applied retroactively. *CBS* at 699.

The holding in *CBS* is in accordance with the Maryland Administrative Procedure Act, State Government Article § 10-101 through 10-139, which requires that a change or implementation of policy by a state agency be accomplished by promulgating a regulation. In addition, the Administrative Procedure Act provides that regulations may only be promulgated prospectively. State Government Article §10-101(g)(1).

### C. *The CBS Doctrine Applies to Both New Policies and Changed Policies.*

The Appellant has asserted that *CBS* does not apply to the case at hand. The Appellant's rationale is that CBS applies only to situations in which an administrative agency *changes* its position, not to situations in which an agency propounds a *new* one. (Appellant's Brief, 30).

The Appellee submits that the Tax Court was correct in applying *CBS* to this case, and that the Appellant's analysis of *CBS* is doubly misguided. First, the Appellant's position in this case does represent a change of position. Second, *CBS* is not limited to changed positions as contrasted with new ones.

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1. *The Appellant's Position in this Case Represents a Changed Position.* Prior to its implementation of an aggressive audit policy of Delaware IPPCs, the Appellant did have a position as to when businesses without physical presence in Maryland should pay Maryland income tax. That policy was implicit in the fact that Crown Parent was audited in 1993 for tax years 1989, 1990 and 1991; that the existence of a Delaware IPPC was evident during that audit; and that the Appellant did not see fit to assert any deficiency with respect to that company. See the trial testimony of Jeffrey Marks at (E. 787.), as discussed above in the Statement of Facts.

In addition, the Appellant's prior policy was explicitly set forth in ADR No. 2, "Interstate Commerce Tax Act – Domestic and Foreign Corporations – Nexus Requirement – Apportionment of Corporate Net Income," promulgated by the Appellant on January 1, 1989. In this Release, the Appellant states that every "corporation . . . doing business within Maryland . . . shall file a true and accurate return of its income or loss for the taxable period." The Release defines "doing business within Maryland" as having a business location within Maryland, having a representative in Maryland, or engaging in certain activities other than those that do not cause an entity to be taxable under P.L. 86-272. A copy of the Release is attached as Appendix B. Nothing in this Release (or in any other public release, pronouncement or regulation issued by the Appellant) has ever suggested that a corporation without property, employees, sales activity, or physical presence in the State of Maryland would be subject to Maryland income tax.

2. *CBS is Applicable to New Administrative Positions as Well as Changes in Position.* Even the most cursory review of this Court's decision in *CBS* reveals that its holding was not limited to situations in which an administrative agency *changed* its policy. For example, in distinguishing *Consumer Protection v. Consumer Pub., 304 Md. 731 (1985)*, this Court stated that the "administrative agency did not change existing law or even *formulate* rules of widespread application." *CBS* at 694 (emphasis added). In distinguishing *CBS* from another case, this Court stated that the latter "was not a case in which materially modified *or new standards* were applied retroactively. . . ." *CBS* at 694 (emphasis added). Indeed, this Court specifically noted that *CBS* involved a *new policy*: "the effect of the Appellant's audit was to announce a substantially *new* generally applicable policy." *CBS* at 699 (emphasis added).

In fact, any distinction between a new and a changed policy would run counter to the Administrative Procedure Act. The definition of a "regulation" in State Government Article § 10-101(g) provides that "regulation" means "a statement or an amendment" (emphasis added). Clearly, the use of the phrase "statement or amendment" was designed to encompass both new as well as changed statements of policy.

The requirement of administrative rulemaking in instances of both new and changed policies is not unique to *CBS*. It can be found in the Supreme Court decision on which *CBS* is predicated. In *S.E.C v. Chenery Corp., 332 U.S. 194 (1947)*, the Supreme Court stated: "since the [Securities Exchange] Commission, unlike a court, does have the ability

to make *new* law prospectively through the exercise of its rule-making powers, it has less reason to rely upon ad hoc adjudication to formulate *new standards* of conduct. . . ." *Chenery* at 202 (emphasis added). The administrative policy at issue in *Chenery*, which the Supreme Court held required rulemaking, was a new policy.

3. *Reliance.* There is essentially the same reliance in this case as in *CBS*, namely, the taxpayer continued its activities — and continued to prepare its income tax returns — based on the Appellant's acquiescence and acceptance of these activities and returns in the past. However, the Appellant attempts to distinguish this case from *CBS*, where the taxpayer's returns for prior years had been audited and approved by the Appellant, on the ground that it was Crown Parent, not the Appellee itself, that filed income tax returns with the State of Maryland.

This argument borders on sophistry. This case is only before this Court because during a routine audit of Crown Parent, the Appellant's auditor had before him all the facts necessary to ascertain that a Delaware IPPC existed. These facts are no different than those that existed in prior audits of Crown Parent. It is ironic that while the Appellant contends that the Appellee and Crown Parent are alter-egos, the Appellant nevertheless contends that the Appellee was not entitled to rely on prior audits of Crown Parent.

The cases cited by the Appellee to support its interpretation of *CBS* are not on point. For example, the Appellant contends that both *Baltimore Gas & Electric Co. v. Public Service Commission, 305 Md. 145 (1986)*, and

*Consumer Protection Division v. Consumer Publishing Company, 304 Md. 731 (1985)*, support its reliance argument. However, in both *Baltimore Gas and Electric* and *Consumer Protection*, this Court found that the agencies in question had not enacted substantially new or changed policies. See *Baltimore Gas & Electric* at 168 (the Public Service Commission's interpretation of the statute in question did not "differ significantly from that originally articulated by the Commission . . ."), and *Consumer Protection* at 756 ("the Consumer Protection Division did not change existing law or even formulate rules of widespread application . . .").

**D. *The Reasons For Requiring Rulemaking.***

The reasons for requiring an agency to effect a new or changed policy of broad application by rulemaking rather than ad hoc adjudication were catalogued by David L. Shapiro in his article, "The Choice of Rulemaking or Adjudication In The Development of Administrative Policy," 78 *Harvard Law Review* 921 (1965). Among the reasons to prefer rulemaking to adjudication adduced by Professor Shapiro are:

1. *Notice and opportunity for comment.* The rulemaking process requires the agency to allow participation in the process by all those who may be affected by the rule. No such opportunity is afforded by adjudication. Citing a Federal Trade Commission statement, Professor Shapiro states that "quite apart from considerations of fairness, participation in the rulemaking process is likely to assist the agency in formulating a practical and sound rule." *Id.* at 930.

The Comptroller's analysis of this case could have been considerably aided by public participation.

For example, the Notice of Final Determination provides the Appellee "did not have *substantial economic substance*." (E. 17; emphasis added). This sentiment was echoed by Patrick White who testified that "the basis of the assessment was predicated" on the fact that [the Appellee] had failed to show "that they had *substantial economic* substance. . . ." (E. 820; emphasis added).

The concept of "substantial economic substance" is central to the Comptroller's case. However, not only has the Comptroller's office failed to propound a definition of this key concept, it was not even conscious of the fact that it invented the term. When asked on cross-examination "[where] do you find a definition of those three words, 'substantial economic substance', in Maryland law?", Mr. White responded: "I think the definition of it stems from case law. The *Armco* case uses the term, which we have used throughout the analysis of this case and other Delaware holding companies. . . . We've used that phrase in the same way that the *Armco* Court used that phrase." (E. 905.)

The truth is that the term does not appear in *Armco*. When presented with the *Armco* decision, and asked to find where that decision either uses or defines the phrase "substantial economic substance," Mr. White responded, "the words 'substantial economic substance' is probably not in here." (E. 906.) After being given further time to refresh his recollection of that decision by re-reading it, Mr. White admitted: "I did not see 'substantial economic substance' in here." (E. 907.) Finally, when asked if he would be surprised that a Lexis "search of the Maryland Court of Appeals decisions, the Court of Special Appeals decisions, the

Attorney General's opinions do not disclose one case or opinion that uses those three words ["substantial economic substance"], Mr. White responded, "I would not be surprised." (E. 908.)

The participation from interested parties that would have come from a notice of proposed rulemaking — and public hearings — would have spared the Comptroller's office the embarrassment of predicating a great number of assessments on an ill-defined three-word phrase, only to learn by cross-examination in the Tax Court that the phrase is not found in the case where the Comptroller believed it to be, and indeed is not found in any Maryland case.

2. *Uniformity of Application*. Another benefit of rulemaking cited by Professor Shapiro is that it requires "uniformity of application." *Id.* at 935. Uniformity is lacking in the Comptroller's approach to IPPCs. To date, the Comptroller has tried two IPPC cases in the Maryland Tax Court. In just those two cases, the Comptroller has advanced inconsistent positions.

In the first case tried before the Maryland Tax Court, *SYL, Inc., v. Comptroller (Maryland Tax Court Appeal No.* C-96-0154-01) (tried just one month prior to this case), counsel for the Appellant stated in the course of his opening statement:

> He wrote that the royalty revenues that SYL is going to be receiving from Syms 'should stay in Delaware for at least a couple of weeks'. Well why is that? Who cares how long money sits

> somewhere? Why was that necessary that the money sit in Delaware? If SYL were truly a company with substantial economic substance, what difference would any of this make. [Transcript of *SYL, Inc. v. Comptroller* (Volume 1, page 30). A copy of this portion of the *SYL* transcript is attached as Appendix C.]

In other words, the Appellant argued that once royalty income is paid by a parent to a subsidiary, if the subsidiary has "substantial economic substance" it should make no difference how long that money remains with the subsidiary.

In this case, however, the Appellant took a different position. Patrick White observed that amounts paid by Crown Parent to Appellee "were being paid in and then returned back almost the same moment, or certainly in the same day." (E. 878-879.) When asked what was the significance of this fact, Mr. White responded: "Well from a Federal standpoint circular flow transactions, transactions where they're essentially on a yo-yo, are disregarded. They are not real transactions." (E. 881.)

In other words, the Appellant has established a heads I win, tails you lose situation. If a taxpayer states that royalty income should remain in a subsidiary, the Appellant takes the position (as it did in *SYL*) that this requirement is not reflective of "substantial economic substance." On the other hand, if royalty payments are, quickly returned to the parent, the Appellant takes the position (as it did in this case) that this is not indicative of a "real transaction." Surely this inconsistent approach to similar transactions would never have survived the formal rulemaking process.

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**E. *The Appellant's Legislative and Regulatory Activities.***

The post-audit conduct of the Appellant is inconsistent with the Appellant's current position that it may tax corporations that lack physical presence in the State of Maryland without formal rulemaking.

In October, 1997, a hearing was held on an emergency regulation proposed by the Board of Public Works. This proposed regulation required, *inter alia*, that any contractor entering into a contract with the State of Maryland include in that contract a provision that the contractor would "not reduce its income subject to tax by claiming deductions for royalty or similar payments for trademarks, tradenames, or intangible property that shift income from the contractor to an affiliated entity that does not file Maryland income tax returns." COMAR 21.05.08.08. In other words, the Board of Public Works, one of whose three members is the Appellant, was attempting to promulgate a regulation that would have the effect of subjecting payments to IPPCs to Maryland income tax; functionally just what the Appellant is seeking in this case.

Testifying in support of this proposed regulation were the then Comptroller, Louis Goldstein, and counsel for the Appellant in this case, Gerald Langbaum. It is hard to square the Appellant's position that its action in this case does not require rulemaking with the Appellant's action of proposing a regulation on this topic. While the Appellant may argue that it was the Board of Public Works and not the Appellant that proposed the regulation in question, the Board of Public Works was acting through one of its members, the Appellant,

with the advice and counsel of the Appellant's counsel. It appears, to use one of the Appellant's favorite characterizations of the Appellee and Crown Parent, that in this case the Board of Public Works and the Appellant were "alter egos."[5]

The Tax Court, in its *SYL* opinion, noted that in 1998, "The [Appellant] . . . attempted to enact legislation . . . to specifically provide for the taxation of foreign holding companies . . ." (App. 17.) The Appellant's sponsorship of such legislation is also hard to explain in the face of the Appellant's current position that the taxation of foreign holding companies can be accomplished through *ad hoc* adjudication and does not even require administrative rulemaking, let alone legislative action.[6]

**F.** ***Summary.*** The Appellee submits that the case at hand is virtually identical to *CBS.* Crown Parent's tax returns, taking the same position the Appellee is now forced to defend, had been previously audited without adjustment. The Appellee relied, and had every right to rely, on that prior audit as evidence of the acceptance of its position by the Appellant.

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5. For a number of reasons, most of which are not relevant to this case, the General Assembly's Joint Committee on Administrative, Executive, and Legislative Review declined to enact this regulation on an emergency basis, and recommended that the Board of Public Works withdraw its non-emergency counterpart regulation.

6. This bill, HB 682, General Assembly Regular Session (1998) was withdrawn before being brought to a vote. A copy of this HB 682 is attached hereto as Appendix D.

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In 1995, the Appellant determined as a matter of internal policy that it would aggressively audit Delaware IPPCs. It developed a theory on which to attack them and has now applied that theory to over 50 taxpayers. (E. 926.) And, for the first time in Maryland tax history, the Appellant has attempted to tax a corporation formed for valid business purposes that has no physical presence in the State of Maryland.

In asserting that the Appellant must proceed by rulemaking, the Appellee is not requesting that this Court require the State to do anything more than many of its sister states have done. For example, seventeen states have adopted prospective statutes or regulations attempting to deal with finance or intellectual property subsidiaries: statutes have been enacted in Indiana, Iowa, Kentucky, Massachusetts, Minnesota, Pennsylvania, Tennessee, and West Virginia; regulations have been promulgated by Arkansas, Florida, Iowa, Massachusetts, New Jersey, New Mexico, North Carolina, South Carolina [*post-Geoffrey*], and Wisconsin.

Based upon the clear holding in *CBS*, as well as the Maryland Administrative Procedure Act, the Appellee submits that the Appellant's attempt to force the Appellee to file Maryland corporate income tax returns without promulgating a formal regulation is both illegal and invalid.

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## IV. THE APPELLEE'S APPORTIONMENT FACTORS MUST BE USED

Maryland requires that each corporation that is subject to Maryland income tax file its own tax return. Parent-subsidiary corporations are not permitted to file consolidated or combined returns, that is tax returns where the income, expense, and other tax items of more than one corporation are reflected together on one return. This is different from the Federal income tax scheme, and that of many states, that provide for the filing of combined or consolidated income tax returns. In requiring that the Appellee file corporate income tax returns based on the apportionment factors of Crown Parent, the Appellant is requiring the Appellee and Crown Parent to apportion their income as if they filed a combined return, and is thus attempting to create an exception to the clear dictates of Maryland law by administrative fiat.

The starting point for any analysis of Maryland income tax reporting obligations of corporations is the Tax General Article of the Maryland Annotated Code, which provides that "Each member of an affiliated group of corporations shall file a separate income tax return." Md. Code Ann., Tax-Gen. § 10-811. This statutory provision is augmented by Regulations that provide that "Corporations included in a consolidated filing for federal income tax purposes shall file separate Maryland returns and compute separate Maryland taxable income." COMAR 03.04.03.05.B.

The Maryland Court of Special Appeals has held that this "separate entities file separate returns" statutory mandate is not subject to equitable adjustment by the Appellant.

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In *Chesapeake Industries v. Comptroller, 59 Md. App. 370, 383 (1984)*, the Court of Special Appeals stated that Maryland law "does not permit, let alone require the Comptroller to disregard this statutory mandate."

It is true that in *Armco* the Court of Special Appeals required that a subsidiary apportion its income using its parent's factors. However, as the Tax Court noted, this rare exception to separate reporting was permitted in the rare case where the subsidiary was a "phantom." The specific factual findings by the Tax Court, discussed above, make this decision inapplicable to the case at hand. Since the Appellee has been expressly found by the Tax Court not to be a phantom corporation, Maryland law requires that the Appellee, if required to file an income tax return in Maryland, file its own return, using its own apportionment factors.

## V. NO PENALTY SHOULD BE IMPOSED.

As previously discussed, the Appellant's assessment involves a novel broadening of a narrow and unique case (*Armco*). Moreover, the Appellee reasonably relied on the results of the First Audit (or the lack thereof).

The Appellee's actions were reasonable. Its reliance on the Appellant's Administrative Release was reasonable. In addition, the Appellee acted in good faith at all times in its belief that it was not required to file Maryland corporate income tax returns.

It should be noted that the same auditor, Jeffrey Marks, who was involved in the present Second Audit was also the

auditor who was involved in the First Audit covering tax years 1987-91 (which are three of the five tax years *again* involved in the Second Audit). Mr. Marks recommended, with respect to the First Audit, that *no* penalties be assessed. Appellee's Exhibit 54, Corporation Income Tax Audit Program, Explanation on p. 18. (E. 958.) The Appellant agreed with this recommendation, and no penalties were assessed for those tax years in the First Audit. Exhibit 54, March 1, 1993 Notice of Proposed Audit Adjustments. (E. 959-960.)

Tax-General Article Section 13-714 provides that penalties may be abated "for reasonable cause." Under the circumstances, including the circumstances that the Appellant's office knew at the time of the First Audit of the Appellee's existence as a Delaware holding company and the amount of its receipts and expenses — and also knew that *Armco* had been decided — there clearly was substantial evidence underpinning the Tax Court's finding of fact that the Appellant's failure to waive penalties in the Second Audit constituted an abuse of the Appellant's discretion.

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## CONCLUSION

For the foregoing reasons, the Opinion and Order of the Maryland Tax Court and the Memorandum opinion of the Circuit Court for Baltimore City should be affirmed, and the Appellant's appeal denied.

Respectfully submitted,

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[Appendix intentionally omitted]

## APPENDIX K — APPELLEE'S MOTION FOR RECONSIDERATION DATED JULY 9, 2003

**IN THE**
**COURT OF APPEALS OF MARYLAND**

SEPTEMBER TERM, 2000

NO. 80

COMPTROLLER OF THE TREASURY,

Appellant,

v.

CROWN CORK & SEAL CO. (DELAWARE), INC.,

Appellee.

## APPELLEE'S MOTION FOR RECONSIDERATION

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*Appendix K*

## MOTION FOR RECONSIDERATION

Crown Cork & Seal Company (Delaware), Inc. ("Crown"), Appellee, pursuant to Maryland Rule 8-605, files this motion for reconsideration with respect to this Court's June 9, 2003 opinion through which it reversed the judgment of the courts below and directed a remand to the Tax Court for further proceedings. In support of this motion, Crown states as follows:

1. Through its opinion, this Court departed from established legal precedent regarding the respect afforded to incorporated entities and adopted a new, expansive and unsupported interpretation of the unitary business concept to reach its conclusion that Maryland could impose its corporation income tax on Crown, a nondomiciliary corporation with no jurisdictional contacts within Maryland;

2. Through its opinion, this Court relied on case law from other jurisdictions that does not support the legal theories or conclusions adopted by this Court;

3. Through its opinion, this Court declined to consider the significant constitutional issue related to the proper method to be used to determine the portion of Crown's income that may be taxable in Maryland; and

4. Through its opinion, this Court improperly concluded that it was appropriate for the Comptroller to adopt a policy to tax nondomiciliary corporations without promulgating a regulation as required under Maryland law.

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Unfortunately for Crown, this Court heard the Comptroller's appeal of the Crown decision immediately following oral argument in the Comptroller's appeal of the Circuit Court decision involving SYL, Inc. (September Term, 2000, No. 76). Moreover, the Court in its June 9, 2003 Opinion dealt with both cases. As a result, Crown was obviously tarred and feathered with the same brush as SYL. The June 9 Opinion begins its review of the SYL evidence with a discussion of the scenario that the "suggestion to create SYL for tax benefit reasons originated from Coventry Financial" and that Coventry Financial's fee was directly tied to the total amount of tax savings. . . ." Opinion, pp. 6-7. Inter-company correspondence was next reviewed, as well as the admission of a SYL's witness, showing that SYL was designed to avoid taxes and "to keep tax auditors from realizing what was going on."

*There is absolutely no such evidence with respect to Crown.* Indeed, Crown's general counsel Richard Kryzyanowski testified as to the non-tax reasons for incorporating Crown including asset protection in the event of hostile takeover (E592-593; 1082), and this testimony was corroborated, without contradiction, by two expert witnesses, A. C. Sondhi, Ph.D., an independent investment and financial advisor, and Arthur Seidel, Esq. an independent intellectual property attorney with over 50 years of experience in the field. (E688-689; 731.)

Moreover, the evidence in the Crown case showed that Crown had shared office space in Wilmington, Delaware, with signage on the building's directory. Crown's officers, moreover, had business cards. (E589;607-614.) Contrasted to this is the admission by the Comptroller's investigator that he visited the wrong office "at a different building" on the other side of I-95,

that he did not ask to meet with the individual responsible for the day-to-day operation of Crown's business, and that indeed he never asked to visit Crown's Wilmington office to review its files and records. (E799-802.)

## STATEMENT OF AUTHORITIES

1. *Through its opinion this Court departed from established legal precedent regarding the respect afforded to incorporated entities and adopted a new, expansive and unsupported interpretation of the unitary business concept to reach its conclusion that Maryland could impose its corporation income tax on Crown, a nondomiciliary corporation with no jurisdictional contacts within Maryland.*

### A. *The opinion of this Court is contrary to established legal precedent regarding the respect afforded to viable incorporated entities.*

Through its opinion, this Court concluded that it could disregard Crown as a legal entity and treat it as a "phantom" corporation to determine whether Crown was subject to the Maryland corporation income tax.[1] The general rule in tax cases

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1. It should be noted that this Court's judicial finding that Crown was a "phantom" corporation or a "sham" or "shell" corporation is contradicted by the position of the Comptroller expressed through the testimony of its principal witness, staff legal advisor attorney Patrick White, who testified that "we could not treat them as sham or shell transactions." (Joint Record Extract ("E") E910.) The Comptroller should be estopped from arguing that Crown should be

(Cont'd)

is that the separate identity of a corporation may only be disregarded in "exceptional situations." *New Colonial Ice Company, Inc. v. Helvering*, 292 U.S. 435 (1934). Moreover, the U.S. Supreme Court has held as follows:

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity. *Moline Properties, Inc. v. Commissioner of Internal Revenue*, 319 U.S. 436 (1943).

Exceptional situations that justify disregarding an entity have only been found in cases where the corporation is devoid of any business substance or indicia of business activities. See *U.S. v. Brager Building and Land Corporation*, 124 F.2d 349 (CA-4, 1941) (no business activities, no officers, no employees, no capital, no bank account, no office and no books or records); and *Paymer v. Commissioner of Internal Revenue*, 150 F.2d 334 (CA-2, 1945) (no meetings after the initial organizational

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disregarded under the doctrine of judicial estoppel. *See Salisbury Beauty Schools v. Board of Cosmetologists*, 268 Md. 32 (1973); *State Roads Comm'n v. Town of Colmar Manor*, 51 Md. App. 240 (1982); *see also Vogel v. Touhey*, CSA No. 01435 (Daily Record, July 7, 2003) (applying judicial estoppel doctrine against a party in a divorce case).

meeting, no office, no bank account, no books or records and no business purpose). Likewise, in *Comptroller v. Armco Export Sales Corporation*, 82 Md. App. 429 (1990), the Court of Special Appeals determined that three domestic international sales corporations ("DISCs") were "phantom corporations" and thus, disregarded those entities. That determination was based on the fact that the DISCs, which did not conduct any activities, did not own any tangible assets, did not have any employees, and were mere paper corporations formed pursuant to the Internal Revenue Code which provided tax incentives to DISCs to encourage United States exports.

Unlike the exceptional circumstances described above, Crown conducted a bona fide business and maintained all indicia of a viable business entity. Through documents and testimony introduced into evidence at the Tax Court, Crown established that it was validly formed for non-tax business reasons and operated under Delaware law, had employees performing services pursuant to written employment agreements, had officers and directors, had business cards, incurred expenses, including substantial federal income tax, related to its operations, maintained bank accounts and books and records, leased separate office space, filed unemployment tax returns and corporate annual reports, owned valuable intellectual property and engaged in licensing and other significant transactions with affiliates and third parties that resulted in Crown earning a substantial amount of income.[2] (E51-E70, E71-E86, E148-E153,

2. Moreover, many of the facts that establish that Crown had substantial economic substance, including the fact that it had significant transactions with third parties, were not present in the appeal involving SYL, Inc. that was decided by this Court with

(Cont'd)

E154-E164, E166-E184, E190-E201, E238-255, E512-E543, E589 and E607-614) Thus, Crown was a viable corporate entity with business substance that should not have been disregarded by this Court for the purpose of determining whether Crown was subject to the Maryland corporation income tax.

Based on the documents and testimony in the record in this matter, the Tax Court concluded that Crown had business substance and should not be disregarded in determining whether it was subject to the Maryland corporation income tax. That determination by the Tax Court was a finding of fact that was based, in part, on inferences the Tax Court drew from the documents and testimony presented to the Tax Court. See *Jacobson v. Commissioner of Internal Revenue*, 915 F.2d 832 (CA-2, 1990) (a court's determination that a corporation lacks economic substance is a finding of fact); *W.D. Haden Company v. Commissioner of Internal Revenue*, 321 F.2d 169 (CA-5, 1963) (whether transactions were made to accomplish a business purpose or non-business purposes is a question of fact); and *Commissioner of Internal Revenue v. Virginia Metal Products, Inc.*, 290 F.2d 675 (CA-3, 1961) (the determination that transactions were entered into for a business purpose is a finding of fact). Under the applicable standard of review, this Court was required to accord substantial deference to the Tax Court's findings of fact, including its conclusion that Crown had business substance and should not be disregarded as an entity. See *Foss Nirsystems, Inc. v. Comptroller of the Treasury*, 2003 Md. App. LEXIS 56

(Cont'd)

Crown's appeal. The issues involved in these appeals are factually-intensive and thus it would be reasonable for this Court to determine that the appeals should be decided differently.

(May 6, 2003) ("Administrative decisions, such as those by the tax court, receive considerable deference by reviewing courts. . . . Therefore, we are constrained to accept the factual findings of the agency if reasonable minds could possibly have reached the same conclusions based upon substantial evidence found in the record."). Moreover, this Court has held as follows:

> ". . . a reviewing court may not substitute its judgment for the expertise of the agency; that we must review the agency's decision in the light most favorable to it; that the agency's decision is prima facie correct and presumed valid; and that it is the agency's province to resolve conflicting evidence and where inconsistent inferences can be drawn from the same evidence it is for the agency to draw the inferences." *Ramsay Scarlett & Co. v. Comptroller*, 302 Md. 825 (1985) (citing *Comptroller v. Haskin*, 298 Md. 681 (1984)).

Thus, the finding by the Tax Court that Crown had business substance was a finding of fact. In addition, the inferences drawn by the Tax Court from the evidence presented before it are entitled to substantial deference by this Court. Therefore, this Court should have respected the Tax Court's findings of fact and related conclusions rather than substituting this Court's judgment with respect to those issues.

Moreover, it is inherently contradictory for this Court to conclude that it can disregard Crown as an entity to determine whether it is subject to the Maryland corporation income tax *and* then to treat Crown as a viable corporate entity by requiring Crown to file a separate-company Maryland corporation income tax return.

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B. *The opinion of this Court is not supported by U.S. Supreme Court unitary business case law precedent.*

Through its opinion, this Court has expanded, in an unprecedented way, the unitary business concept to require a nondomiciliary corporation with no jurisdictional contacts within Maryland to file a separate-company corporation income tax return in Maryland based solely on the fact that the corporation has a unitary relationship with a corporation that conducts business in Maryland. That determination is not in accord with any case law regarding the unitary business concept.

Most of the U.S. Supreme Court unitary business case law addresses the issue of whether a state may tax certain items of income of a corporation that conducts business in the state when that income is earned outside of the state. See *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980); *F.W. Woolworth Co. v. Taxation and Revenue Department of New Mexico*, 458 U.S. 354 (1982); and *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307 (1982) (in *Mobil*, *Woolworth* and *ASARCO*, the Court addressed the taxation of dividends that the taxpayers received from foreign subsidiary corporations); *see also Exxon Corp. v. Department of Revenue of Wisconsin*, 447 U.S. 207 (1980) (in that case, the Court addressed the taxation of income from oil refining, exploration and production activities that were conducted by the taxpayer outside of Wisconsin); *see also Allied-Signal, Inc. v. Division of Taxation*, 504 U.S. 768 (1992) (in that case, the Court addressed the taxation of capital gains that the taxpayer recognized with respect to the sale of corporate stock). In each of those cases, the taxpayers were conducting business in the state and the state was attempting to impose additional tax on

the taxpayer. Thus, those cases are not applicable to this appeal because Crown does not conduct business in Maryland.

The U.S. Supreme Court has also permitted a state to impose tax on the income of nondomiciliary corporations that did not conduct business in the state by including the income and the apportionment factors of those corporations in a combined unitary corporation income tax report with the income and apportionment factors of an in-state taxpayer. *See Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983). However, that case involved the State of California whose legislature had specifically authorized and required the filing of combined unitary tax returns with respect to corporate taxpayers. *Id.* Therefore, that case is not relevant to this appeal because the Maryland legislature has not authorized combined unitary filing, but rather, authorized only separate-company returns for corporate taxpayers. *See* Md. Code Ann., Tax-Gen. § 10-811 and *Chesapeake Industries, Inc. v. Comptroller*, 59 Md. App. 370 (1984). In fact, there are no U.S. Supreme Court cases that have permitted a state to require a nondomiciliary corporation without jurisdictional contacts within a state to file a separate-company corporation tax return based on the jurisdictional contacts of an affiliated corporation.[3]

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3. In fact, requiring a nondomiciliary corporation that does not have any jurisdictional contacts within Maryland to file a separate-company Maryland corporation income tax return appears to conflict with the decision of the United States Supreme Court in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), in which the Court determined that a state may not impose tax under the Commerce Clause unless a corporation has physical presence within the state.

2. *Through its opinion, this Court relied on case law from other jurisdictions that did not address or support the legal theories or conclusions adopted by this Court.*

The theory adopted by this Court is that Crown should be treated as a disregarded entity and, based on its unitary relationship with a Maryland taxpayer, be required to file a separate company corporation income tax return in Maryland. In support of its opinion, this Court relied on the Massachusetts Supreme Judicial Court's opinion in *Syms Corp. v. Commissioner of Revenue*, 436 Mass. 505, 765 N.E.2d 758 (2002), and the South Carolina Supreme Court's opinion in *Geoffrey, Inc. v. South Carolina Tax Commission*, 313 S.C. 15, 437 S.E.2d 13 (1993). This Court's reliance on those cases is misplaced because neither of those courts applied the legal theory or conclusions adopted by this Court. In *Syms*, the Massachusetts Supreme Judicial Court determined that a corporation's royalty and interest expense deductions were improper because the underlying transactions that resulted in the deductions were devoid of economic substance. Massachusetts did not disregard the existence of the nondomiciliary corporation that was a party to the transactions in issue in that appeal and did not attempt to impose tax on that corporation. It simply increased the tax liability of the party which was already subject to Massachusetts tax and claimed the expense deductions, based upon statutory reallocation powers given to the Massachusetts Commissioner similar to those contained in IRC § 482. This Court expressly held in *Comptroller v. Gannett*, 356 Md. 699 (1999), that the Maryland Comptroller held no such power. In *Geoffrey*, the South Carolina Supreme Court determined that a nondomiciliary corporation was doing business in South Carolina and thus, directing its economic activity into the state. Based on

the fact that it did business in South Carolina, South Carolina required the nondomiciliary corporation to file a separate-company South Carolina corporation income tax return. Thus, South Carolina did not disregard the nondomiciliary corporation and did not require that corporation to file a corporation income tax return *based on its relationship with an in-state corporation* but rather on its own business activity within the state.

3. *Through its opinion, this Court declined to consider the significant constitutional issue related to the proper method to be used to determine the portion of Crown's income that may be taxable in Maryland.*

This Court determined that Maryland can require Crown, a nondomicilary corporation with no jurisdictional contacts within Maryland, to file a Maryland corporation income tax return and pay tax on "a portion" of its separate-company income. This Court did not, however, determine what portion of Crown's income should be subject to Maryland corporation income tax. That issue was apparently remanded to the Tax Court to decide.[4] The apportionment issue in this matter involves a significant constitutional issue that Crown respectfully requests this Court to decide.

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4. In *dicta*, the Tax Court and the Circuit Court concluded that if Crown were disregarded and treated as a "phantom corporation" as it was by this Court, that Crown's income would be apportioned to Maryland based on its parent corporation's apportionment factors. That conclusion is consistent with precedent from the Court of Special Appeals. Thus, it appears that a remand of that issue to the Tax Court will likely result in a waste of judicial resources.

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Under U.S. Supreme Court case law, a tax will only be sustained with respect to the Commerce Clause if it satisfies four conditions: 1) it is applied to an activity with a substantial nexus with the taxing State, 2) it is fairly apportioned, 3) it does not discriminate against interstate commerce, and 4) it is fairly related to the services provided by the State. *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). Thus, apportionment is a significant issue with respect to the Commerce Clause. In addition, the apportionment issue was raised throughout the proceedings with respect to this appeal, discussed by the courts below in *dicta*,[5] and briefed by the parties in their submissions to this Court.

Crown takes the view that if it is subject to the Maryland corporation income tax, the apportionment method designated and sanctioned by the Maryland legislature is the appropriate method of apportioning its income to the state (i.e. that the separate-company apportionment factors of Crown be used to apportion the separate-company income of Crown). Md. Code Ann., Tax-Gen. § 10-402. The Comptroller's view is that Crown should apportion its separate company income using the separate-company apportionment factors of Crown's parent corporation. To require one corporation to apportion its income using the apportionment factors of another company is: 1) not authorized by Maryland law or the law of any other state; 2) contrary to the U.S. Supreme Court's Commerce Clause jurisprudence because the factors used to apportion a

5. See *Crown Cork & Seal (Delaware) Inc. v. Comptroller of the Treasury*, Circuit Court for Baltimore City, No. 24-C-99-002388 AA (March 17, 2000); and *Crown Cork & Seal (Delaware) Inc. v. Comptroller of the Treasury*, Maryland Tax Court, No. C-97-0028-01 (April 26, 1999).

corporation's income to a state must bear a reasonable relationship to the manner in which the corporation earns income and thus using one corporation's apportionment factors to apportion another corporation's income is unconstitutional; and 3) incompatible with U.S. Supreme Court unitary business case law which requires that the income and apportionment factors of each corporation in a unitary group be included in computing the tax of the unitary business. In fact, no federal or state court outside Maryland has ever concluded that a corporation's income should be apportioned based on the property, payroll and sales factors of an affiliated corporation.

4. *Through its opinion, this Court improperly concluded that it was appropriate for the Comptroller to adopt a policy to tax nondomiciliary corporations without promulgating a regulation as required under Maryland law.*

This Court improperly determined that the adoption of a policy is *not* a change in policy and therefore, the promulgation of a regulation with respect to that policy is not required under Maryland law. Under *CBS, Inc. v. Comptroller*, 319 Md. 687 (1990) and the Maryland Administrative Procedures Act, Md. Code Ann., State Gov't §§10-101 through 10-139, the Comptroller is required to prospectively promulgate a regulation for new or changed tax policies of general application. Prior to 1995, Maryland did not seek to subject corporations, such as Crown, to the Maryland corporation income tax. Beginning in 1995, the Comptroller began asserting deficiencies against one class of nondomiciliary corporation - foreign trademark protection companies, based on the in-state activities of their affiliated corporation. That change materially modified taxing jurisdiction

standards and the settled expectations of corporations that did not conduct business in Maryland. However, no regulations were promulgated and no legislation was enacted to effect that change in jurisdictional standards. Therefore, the Comptroller should be prohibited from imposing those jurisdictional standards until it promulgates a prospective regulation.

WHEREFORE, Crown respectfully requests that this Court grant this Motion for Reconsideration, consider the issues raised herein and issue an opinion directing that the Maryland corporation income tax assessment issued by the Comptroller against Crown in this matter be stricken in its entirety.

Respectfully submitted,

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s/ Daryl J. Sidle
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July 9, 2003

## APPENDIX L — STATUTES AND REGULATIONS FROM OTHER STATES

### STATE-LAW, NC-TAXRPTR ¶92-089, SEC. 105-130.7A. ROYALTY INCOME REPORTING OPTION.—

**GENERAL STATUTES OF NORTH CAROLINA, 1943, CHAPTER 105 TAXATION, SUBCHAPTER I LEVY OF TAXES, ARTICLE 4 Income Tax, Part 1 Corporation Income Tax.**

**Sec. 105-130.7A.—**

(a) *Purpose.*—Royalty payments received for the use of trademarks in this State are income derived from doing business in this State. This section provides taxpayers with an option concerning the method by which these royalties can be reported for taxation when the recipient and the payer are related members. As provided in this section, these royalty payments can be either (i) deducted by the payer and included in the income of the recipient, or (ii) added back to the income of the payer and excluded from the income of the recipient.

(b) *Definitions.*—The following definitions apply in this section:

(1) "Component member."—Defined in section 1563(b) of the Code.

(2) "North Carolina royalty."—An amount charged that is for, related to, or in connection with the use in this State of a trademark. The term includes royalty and technical fees, licensing fees, and other similar charges.

(3) "Own."—To own directly, indirectly, beneficially, or constructively. The attribution rules of section 318 of the Code apply in determining ownership under this section.

(4) "Related entity."—Any of the following:

a. A stockholder who is an individual, or a member of the stockholder's family enumerated in section 318 of the Code, if the stockholder and the members of the stockholder's family own in the aggregate at least eighty percent (80%) of the value of the taxpayer's outstanding stock.

b. A stockholder, or a stockholder's partnership, limited liability company, estate, trust, or corporation, if the stockholder and the stockholder's partnerships, limited liability companies, estates, trusts, and corporations are component members with respect to the taxpayer.

c. A corporation, or a party related to the corporation in a manner that would require an attribution of stock from the corporation to the party or from the party to the corporation under the attribution rules of section 318 of the Code, if the taxpayer owns at least eighty percent (80%) of the value of the corporation's outstanding stock.

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(5) "Related member."—A person that, with respect to the taxpayer during any part of the taxable year, is one or more of the following

a. A related entity.

b. A component member.

c. A person to or from whom there would be attribution of stock ownership in accordance with section 1563(e) of the Code if the phrase '5 percent or more' were replaced by 'twenty percent (20%) or more' each place it appears in that section.

(6) "Royalty payment."—Either of the following:

a. Expenses, losses, and costs paid, accrued, or incurred for North Carolina royalties, to the extent the amounts are allowed as deductions or costs in determining taxable income before operating loss deduction and special deductions for the taxable year under the Code.

b. Amounts directly or indirectly allowed as deductions under section 163 of the Code, to the extent the amounts are paid, accrued, or incurred for a time price differential charged for the late payment of any expenses, losses, or costs described in this subdivision.

(7) "Trademark."—A trademark, trade name, service mark, or other similar type of intangible asset.

(8) "Use."—Use of a trademark includes direct or indirect maintenance, management, ownership, sale, exchange, or disposition of the trademark.

(c) *Election.*—For the purpose of computing its State net income, a taxpayer must add royalty payments made to, or in connection with transactions with, a related member during the taxable year. This addition is not required for an amount of royalty payments that meets either of the following conditions:

(1) The related member includes the amount as income on a return filed under this Part for the same taxable year that the amount is deducted by the taxpayer, and the related member does not elect to deduct the amount pursuant to G.S. 105-130.5(b)(20).

(2) The taxpayer can establish that the related member during the same taxable year directly or indirectly paid, accrued, or incurred the amount to a person who is not a related member.

(d) *Indirect Transactions.*—For the purpose of this section, an indirect transaction or relationship has the same effect as if it were direct.

(As added by Ch. 327 (H.B. 1157 and S.B. 972), Laws 2001, effective January 1, 2001.)

*Appendix L*

**STATE-REG, AR-TAXRPTR-99 ¶14-816, REG. 1996-3. APPORTIONMENT OF BUSINESS INCOME ARISING FROM INTRAGROUP INTANGIBLE LICENSING TRANSACTIONS—**

Arkansas Regulation, Reg. 1996-3. **Apportionment of Business Income Arising From Intragroup Intangible Licensing Transactions.—**

Pursuant to the authority provided in *Ark. Code Ann.* §19-1-208 (1987), *Ark. Code Ann.* §26-18-301 (1987) and *Ark. Code Ann.* §25-15-201, et seq. (1987) (the Arkansas Administrative Procedures Act), the Director of the Arkansas Department of Finance and Administration and the Commissioner of Revenue for the State of Arkansas do hereby promulgate the following Regulation. This Regulation is to be read in conjunction with the previous Regulations of the Department of Finance and Administration ("Department") and laws of this State, for the administration of Article IV of the Multistate Tax Compact as adopted in Arkansas and found at *Ark. Code Ann.* §26-5-101 ("AMTC") and the Uniform Division of Income for Tax Purposes Act as adopted in Arkansas and found at *Ark. Code Ann.* §26-51-701 et seq. ("AUDITPA").

1. *Determination.*

a. In accordance with the terms of *Ark. Code Ann.* §26-5-101 IV-18 and *Ark. Code Ann.* §26-51-718, the Director determines that the allocation and apportionment provisions of the AMTC and the AUDITPA do not fairly

represent the extent of business activity in the State of Arkansas for taxpayers described in paragraph 3.

b. A corporation which owns, licenses or manages intangible property has nexus with Arkansas for purposes of filing a corporate income tax return when the corporation seeks the benefit of economic contact with Arkansas by directing its economic activity at this State through the licensing of these intangibles in an intragroup intangible licensing transaction.

2. *Definitions.* The following words and terms when used in this Regulation shall have the following meanings:

a. "Group" means two or more corporations which are owned or controlled, either directly or indirectly, by the same interests. Corporations which are eligible for inclusion in a consolidated group for the purposes of filing a consolidated return under the Internal Revenue Code are members of a group. However, corporations which are not eligible for inclusion in a federal consolidated return are still part of a group for the purposes of this regulation if there is common ownership, management or control of the corporations or other factors which demonstrate that one corporation has sufficient influence over the affairs of another to cause the corporations to enter into business transactions with each other.

b. "Passive intangible holding company" means a corporation which derives some or all of its income from the management and licensing of intangible assets. As used in this Regulation, the terms "passive intangible holding

company" and "licensor" shall be recognized as meaning the same corporation.

c. "Intragroup intangible licensing transaction" means a license of intangible property rights between two or more members of a group, if one of the parties to the transaction is a passive intangible holding company. Intragroup intangible licensing transactions shall include, licensing of trademarks, tradenames, patents, copyrights, and any other transaction authorizing the use of intangible property in this State.

d. "Intangible income" means income generated by an intragroup intangible licensing transaction.

e. "Licensee" means the group member which recognizes an expense for the use of the passive intangible holding company's intangible property.

f. "Measuring activity" means such action on the part of the licensee which, pursuant to the terms of a licensing agreement, serves as the basis for determining the extent of the licensee's liability for payment of intangible income.

3. a. *Application.* This Regulation shall apply only to taxpayers subject to the tax imposed by the Income Tax Act of 1929 (*Ark. Code Ann.* §26-51-101 et seq. (1987)) which have the following characteristics:

i. The taxpayer is a passive intangible holding company;

ii. The taxpayer receives business income from intragroup intangible licensing transactions with one or more other members of the same group doing business within the jurisdiction of this State; and

iii. At least one of the other members of the same group from which business income is received by the taxpayer is subject to the tax imposed by the Income Tax Act of 1929 (*Ark. Code Ann.* X26-51-101 et seq. (1987)).

b. A passive intangible holding company shall not be subject to the provisions of this regulation for income derived from any intragroup intangible licensing transaction if the licensee does not claim a deduction on its Arkansas income tax return for expenses associated with the intragroup intangible licensing transaction. If the licensee elects to forego this deduction, the passive intangible holding company shall not be required to report the income from the intragroup intangible licensing transaction for Arkansas income tax purposes.

4. *Business Income.*

a. Where a taxpayer meeting the requirements of paragraph 3 has income from sources both within and without this State, the amount of business income from sources within this state shall be determined pursuant to *Ark. Code Ann.* §§26-5-101 IV-9 and 26-51-709 except as modified by this regulation.

b. If a passive intangible holding company has income both from intragroup intangible licensing transactions and from other sources, the income derived from sources other than intragroup intangible licensing transactions shall not be subject to Arkansas income tax unless the income would have been taxable in Arkansas regardless of the intragroup intangible licensing transactions. The purpose of this regulation is to require passive intangible holding companies to apportion income derived from intragroup intangible licensing transactions and pay Arkansas income tax on that apportioned income. This regulation is not intended to require the apportionment of other income which would not have otherwise been subject to Arkansas income tax.

5. *Sales Factor-Intragroup Intangible Licensing Transactions.* The Director of the Arkansas Department of Finance and Administration hereby determines that the sales factor outlined in Ark. Code Ann. §26-51-217 and Ark. Code Ann. §26-5-101 IV(17) does not fairly represent the extent of business activity in Arkansas for passive intangible holding companies which derive income from intragroup intangible licensing transactions. Pursuant to the authority provided in Ark. Code Ann. §26-51-718(d) and Ark. Code Ann. §26-5-101(18)(d) the Director determines that for purposes of computing the sales factor of a passive intangible holding company, sales or receipts arising from an intragroup intangible licensing transaction are in this State and shall be included in the numerator of the sales factor as follows:

a. If the licensing agreement states a method of measuring the activity between the licensor and licensee

which accurately reflects the licensor's business activity attributable to this State, then the sales or receipts shall be included in the numerator of the sales factor as provided in the licensing agreement.

b. If the licensing agreement does not state a method of measuring the activity between the licensor and licensee, then the measuring activity shall be based on one of the following methods that accurately reflects the licensor's business activity attributable to this State:

1. If licensee is engaged in an activity which generates sales or receipts, the numerator of the sales factor shall include licensee's percentage of sales in this State compared to the licensee's total sales; or

2. If licensee is engaged in an activity which does not generate sales or receipts, the numerator of the sales factor shall include licensee's percentage of units produced, or cost of units produced, in this State compared to the licensee's total units produced, or total cost of units produced; or

3. If neither of the above methods accurately represent the licensor's business activity in this state, the licensor may petition for or the Director of the Department of Finance and Administration may require any other method which will accurately represent the licensor's business activity attributable to this State.

c. If the licensing agreement states a method of measuring the activity between the licensor and licensee in addition to a specifically stated dollar amount, the sales or receipts attributable to this State shall be based on the stated measuring activity plus the specifically stated dollar amount computed based on one of the methods stated in 5(b) which accurately reflects the licensor's business activity attributable to this State.

6. *Examples.* The following examples are provided as guidance for purposes of determining whether an intangible income measuring activity is deemed to be readily identifiable to a specific activity occurring within a unique geographic location.

a. A licensing agreement provides that royalty income is to be based upon a percentage of licensee's total sales. Such a measuring activity accurately reflects the licensor's business activity occurring within Arkansas due to the fact a licensor may determine the specific geographic location of the sales which generated the licensor's entitlement to income as outlined in paragraph 5(a).

b. A licensing agreement provides that royalty income is to be based upon the number of stores displaying a licensed trademark. Such a measuring activity accurately reflects the licensor's business activity occurring within Arkansas due to the fact a licensor may determine the specific geographic location of the stores which generated the licensor's entitlement to income as outlined in paragraph 5(a).

c. A licensing agreement provides that royalty income is to be based upon a fixed quarterly amount. Such a measuring activity is not readily identifiable to a specific activity occurring within a unique geographic location due to the fact the royalty income is not based upon an identifiable activity. If the licensee's business activity generates sales or receipts, the numerator of the licensor's sales factor shall be calculated as outlined in paragraph 5(b)(1) of this regulation. If the licensee's business activity does not produce sales or receipts, then the numerator of the licensor's sales factor shall be calculated as outlined in paragraph 5(b)(2) of this regulation.

7. *Effective Date.* This Regulation shall be effective for tax years beginning on or after January 1, 1996.

8. *Withdrawal.* This Regulation replaces Revenue Policy Statement 1995-2, which is withdrawn.

9. *Penalty.* No penalty shall be assessed against any taxpayer for failure to make estimated tax payments for the first year a tax return is due as a result of this regulation.

(Adopted effective for tax years beginning on or after January 1, 1996.)

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**STATE-REG, FL-TAXRPTR ¶13-507,**
**RULE 12C-1.011. TAX IMPOSED.—**

Florida Regulation, **Rule 12C-1.011.—**

(1) The following activities, notwithstanding others within the meaning of taxable privileges described in *s. 220.02*, F.S., will be construed as conducting business, earning or receiving income in this state, or constitute those activities of a resident or citizen of this state for purposes of this tax, and corporations participating therein are subject to taxation unless exempted by the constitution or the laws of the United States or this state:

(a) Incorporation in Florida. A Florida corporation is required to file a Florida corporate income/franchise tax return even though it has no physical existence or activity that takes place in Florida and it does business exclusively in other states or countries.

(b) Maintaining an office or other place of business in this state. If a salesman holds out his home as an office, the corporation will be deemed to maintain an office in this state, regardless of whether the salesman is reimbursed for "office space".

(c) 1. Owning or leasing real or tangible personal property in this state.

2. Out-of-state leasing companies will become subject to the tax if tangible personal property that is leased to individuals or corporations, residing or existing outside the state, is transferred to a Florida location. A lessee company

that routinely brings property into Florida will create a presumption that the leasing company's property was brought into Florida. Unless the leasing company can show the property did not enter this state the leasing company will be subject to tax. Thus, leasing aircraft to commercial airlines that routinely fly aircraft into Florida will subject the leasing company to the tax. If the leasing company cannot determine whether the specific aircraft leased is flying into Florida, there will be a presumption that the aircraft has flown into the state if the airline that leased the aircraft routinely flies into Florida. However, if the leasing corporation can demonstrate that its aircraft are not flown into the state, the leasing companies will not be subject to Florida tax. Similarly, leasing railroad cars to shippers who, in turn, engage the services of railroad companies to haul the cars, which travel through Florida, will also subject the leasing company to tax within this state.

3. If a lease is treated as a conditional sales contract for federal tax purposes, the lessor shall not become subject to the Florida corporate income/franchise tax solely because of this paragraph. The making of a safe harbor election for federal tax purposes will not affect the determination for Florida tax purposes of whether the substance of the lease is a conditional sales contract.

(d) Maintaining within the state a research facility for the exclusive use of a company.

(e) Maintaining in this state an inventory or merchandise or material for sale, distribution or manufacture, regardless of whether in public, owned or rented warehouses.

(f) Maintaining in this state an inventory of tangible personal property on consignment to dealers or agents for sale or display.

(g) Displaying the corporation's merchandise in leased space on a prolonged or recurring basis.

(h) Assembling, installing, servicing or repairing the taxpayer's products in this state by its agents or employees.

(i) Accepting orders in this state by its employees.

(j) Selling goods through mobile stores (such as trucks with driver sales-persons).

(k) Making sales that are approved in the state by "independent contractors" who do not hold themselves out as engaged in selling, or soliciting orders for the sale of, more than one principal; or making sales through the use of representatives in this state, when activities engaged in exceed those protected by P.L. 86-272 (15 U.S.C. ss. 381-384), which is incorporated by reference in *Rule 12C-1.0511*, F.A.C.

(l) Having employees that are present in the state and that perform functions other than the solicitation of sales within Florida.

(m) Performing any service within the state.

(n) Having corporate officers who have permanent or extended temporary residency (3 months in the aggregate

of a 12 month period) within the state who make management decisions while residing in the state. If the only officer of the corporation or a key officer of the corporation is residing within the state, management of the corporation is presumed to be occurring within the state.

(o) Selling, managing, or providing consulting services in Florida for intangible assets. (Example, investment companies, trusts, brokers.) This does not include out-of-state corporations whose only activity is to manage out-of-state assets for Florida residents. For example, a New York investment company that continues to manage investments for a person who is now a Florida resident will not be subject to the tax for this limited connection with the state.

(p) 1. Selling or licensing the use of intangible property in Florida for taxable years beginning on or after January 1, 1994. For example, licensing the use of a trade name or trademark or patent to a business entity located in Florida will subject a corporation to the corporate income tax.

2. Corporations that during tax years beginning before January 1, 1994, not only licensed the use of a trade name or trademark to a business entity located in Florida, but also provided management services within Florida (including directing the purchases of supplies, on-site inspections, and training seminars within Florida) were subject to the Florida corporate income tax for all years these services were performed.

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(q) Conducting seminars in the state.

(r) 1. Conducting management training courses for franchisees or affiliated corporations in the state.

2. Regularly or systematically visiting franchisees or affiliated corporations in the state in order to advise on business matters.

(s) Earning or receiving interest by a financial organization, as described in *s. 220.15(6)*, F.S., from loans secured by real or tangible property located in this state irrespective of place of receipt.

(t) Operating professional sports teams which engage in professional sports activities in this state. There are a number of factors which are indicative of whether out-of-state corporations which engage in professional sports activities in this state are conducting business or deriving income within the meaning and intent of *s. 220,11(1)*, F.S.

1. Prior to the regular playing season the team may provide training for its athletes (players) including coaches, staff, etc., at facilities located in Florida. In the regular course of training, the teams will engage in practice or exhibition games in Florida.

2. During the regular playing season the team will play Florida-based teams in Florida.

3. After the close of the regular playing season the team may participate in playoff or championship games in Florida.

4. The corporation may have owned or rented real and tangible property in Florida for the conduct of training or other activities.

5. The corporation shares in gate receipts from games its teams play in Florida.

6. The corporation shares in radio and television receipts from local stations and from networks pursuant to the league contract, some portion of which is attributable to games played in Florida.

(u) Transportation companies traveling in Florida. All corporate transportation companies are subject to the Florida corporate tax and are required to file Florida corporate tax returns whenever they have revenue miles in this state, as the term "revenue miles" is defined in *s. 220.151*, F.S. Transportation companies that deliver or pick up goods in this state, as well as corporations that do not have a point of origin or termination within this state, are subject to the Florida Income Tax Code whenever they have revenue miles in Florida.

(v) Foreign (out-of-state) corporations not otherwise subject to the law but who are partners or members of Florida partnerships or joint ventures are subject to the law by virtue of their membership in such partnerships or joint ventures.

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Florida partnerships are partnerships doing business, deriving income, or existing in Florida. A partnership will be considered to be existing within Florida if an active partner who participates in management decisions has permanent or extended temporary residency (for 3 months in the aggregate of a 12 month period) within the state. If an active partner is residing within the state, management of the partnership is presumed to be occurring within the state.

(w) Insurers.

1. The issuing of policies of insurance or contracts of annuity under a certificate of authority issued by the Florida Department of Insurance where the policies or contracts are to be performed in Florida or where the policies insure or cover persons, property, subjects or risks located or resident in Florida.

2. The collecting of premiums on policies of insurance or contracts of annuity on such persons, property, subjects, or risks as described in 1. above, when such policies were initially issued by an insurer possessing a certificate of authority issued by the Florida Department of Insurance.

3. The issuing of policies of insurance or contracts of annuity or the collecting of premiums without possessing a certificate of authority issued by the Florida Department of Insurance, when the issuing or collecting insurer would have been required to obtain a certificate of authority to engage in those activities.

4. The entering into contracts of reinsurance when such contracts of reinsurance are placed with an approved reinsurer by a ceding insurer domiciled or resident in this state as defined in Chapter 624, F.S., or by either an artificial entity domiciled or resident in this state or a political subdivision of this state where either the artificial entity or political subdivision are engaged in self insurance.

5. Surplus lines insurers with an office or employees located in this state.

(2) The following activities will not, in themselves, subject a foreign (non-Florida) corporation to the income/ franchise tax. However, these exempted activities will not relieve a corporation from taxation if the corporation is otherwise subject to taxation.

(a) Maintaining an account in a Florida bank or savings association.

(b) Holding stock in a Florida corporation or a corporation that is subject to the Florida corporate income/ franchise tax.

(c) Having an independent Florida accountant, attorney, or bookkeeper maintain accounting records, audit, or do tax preparation.

(d) Salesmen of the corporation soliciting sales of tangible personal property within Florida, provided none of

the activities itemized in subsection (1), or any other activities which will subject the corporation to tax, are performed. The fact that the salesmen reside within the state will not subject the corporation to the tax.

(e) Salesmen maintaining samples to demonstrate the product or give free samples to a customer. The samples may not be sold.

(f) Providing company cars to salesmen.

(3) Cross-reference: *Rule 12C-1.022*, F.A.C.

(4) A taxpayer's regular tax liability is equal to 5 1/2 percent of the taxpayer's net income for the taxable year. However, Florida imposes a corporate alternative minimum tax (AMT). Corporations which pay federal AMT are required to compute Florida AMT. These corporations must compute both regular tax liability and AMT liability. The Florida tax due is the greater of these two amounts. Taxpayers use federal alternative minimum taxable income after the federal exemption allowed under s. 55(d)(2), I.R.C., which is incorporated by reference in *Rule 12C-1.0511*, F.A.C., as the starting point in computing Florida AMT. The Florida additions, subtractions and $5,000 exemption are generally the same regardless of the starting point. However, the amounts for some additions or subtractions may differ. For example, there is an adjustment to the addition of interest that is exempt for federal tax purposes or the addback of the federal net operating loss. The Florida AMT rate is 3.3 percent of Florida AMT net income. Cross-reference: *Rule 12C-1.013*(18), F.A.C.

## *Appendix L*

(Adopted January 19, 1973; amended October 20, 1973; August 23, 1976; December 18, 1983; December 21, 1988; January 30, 1990; April 8, 1992; May 17, 1994; March 18, 1996; March 13, 2000.)

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**STATE-REG, IA-TAXRPTR ¶14-474, RULE 701 52.1(422). WHO MUST FILE.—**

Iowa Regulation, **Rule 701 52.1(422).—**

Every corporation, organized under the laws of Iowa or qualified to do business within this state or doing business within Iowa, regardless of net income, shall file a true and accurate return of its income or loss for the taxable period. The return shall be signed by the president or other duly authorized officer. If the corporation was inactive or not doing business within Iowa, although qualified to do so, during the taxable year, the return must contain a statement to that effect.

For tax years beginning on or after January 1, 1989, every corporation organized under the laws of Iowa, doing business within Iowa, or deriving income from sources consisting of real or tangible property located or having a situs within Iowa, shall file a true and accurate return of its income or loss for the taxable period. The return shall be signed by the president or other duly authorized officer.

For tax years beginning on or after January 1, 1995, every corporation organized under the laws of Iowa, doing business within Iowa, or deriving income from sources consisting of real, tangible, or intangible property located or having a situs within Iowa, shall file a true and accurate return of its income or loss for the taxable period. The return shall be signed by the president or other duly authorized officer. For tax years beginning on or after January 1, 1999, every corporation doing business within Iowa, or deriving income from sources

consisting of real, tangible, or intangible property located or having a situs within Iowa, shall file a true and accurate return of its income or loss for the taxable period. The return shall be signed by the president or other duly authorized officer.

Political organizations described in Internal Revenue Code Section 527 which are domiciled in this state and are required to file federal Form 1120POL and pay federal corporation income tax are subject to Iowa corporation income tax to the same extent as they are subject to federal corporation income tax.

Homeowners associations described in Internal Revenue Code Section 528 which are domiciled in this state and are required to file federal Form 1120H and pay federal corporation income tax, are subject to Iowa corporation income tax to the same extent as they are subject to federal corporation income tax.

**52.1(1)** *Definitions.* a. *Doing business.* The term "doing business" is used in a comprehensive sense and include all activities or any transactions for the purpose of financial or pecuniary gain or profit. Irrespective of the nature of its activities, every corporation organized for profit and carrying out any of the purposes of its organization shall be deemed to be "doing business". In determining whether a corporation is doing business, it is immaterial whether its activities actually result in a profit or loss.

For the period from July 1, 1986, through December 31, 1988, the term "doing business" does not include placing of liquor in bailment pursuant to 1986 Iowa Acts, chapter

1246, section 603, if this is the corporation's sole activity within Iowa. Any activities by corporate officers or employees in Iowa in addition to bailment are "doing business" and will subject the corporation to corporation income tax.

b. *Representative.* A person may be considered a representative even though that person may not be considered an employee for other purposes such as the withholding of income tax from commissions.

c. *Tangible property having a situs within this state.* The term "tangible property having a situs within this state" means that tangible property owned or used by a foreign corporation is habitually present in Iowa or it maintains a fixed and regular route through Iowa sufficient so that Iowa could constitutionally under the 14th Amendment and Commerce Clause of the United States Constitution impose an apportioned ad valorem tax on the property. *Central R. Co. v. Pennsylvania*, 370 U.S. 607, 82 S.Ct. 1297, 8 L.Ed 2d (1962); *New York Central & H. Railroad Co. v. Miller*, 202 U.S. 584, 26 S.Ct. 714, 50 L.Ed. 1155 (1906); *American Refrigerator Transit Company v. State Tax Commission*, 395 P.2d 127 (Or. 1964) *Upper Missouri River Corporation v. Board of Review, Woodbury County*, 210 N.W. 2d 828.

The term also includes every foreign corporation which has acquired a commercial domicile in Iowa and whose property has not acquired a constitutional tax situs outside of Iowa.

d. *Intangible property located or having a situs within Iowa.* Intangible property does not have a situs in the

physical sense in any particular place. *Wheeling Steel Corporation v. Fox*, 298 U.S. 193, 80 L.Ed. 1143, 56 S.Ct. 773 (1936); *McNamara v. George Engine Company, Inc.*, 519 So.2d 217 (La. App. 1988). The term "intangible property located or having a situs within Iowa" means generally that the intangible property belongs to a corporation with its commercial domicile in Iowa or, regardless of where the corporation which owns the intangible property has its commercial domicile, the intangible property has become an integral part of some business activity occurring regularly in Iowa. *Beidler v. South Carolina Tax Commission*, 282 U.S. 1, 75 L.Ed. 131, 51 S.Ct. 54 (1930); *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993), cert. denied, 114 S.Ct. 550 (1993). The following is a noninclusive list of types of intangible property: copyrights, patents, processes, franchises, contracts, bank deposits including certificates of deposit, repurchase agreements, loans, shares of stocks, bonds, licenses, partnership interests including limited partnership interests, leaseholds, money, evidences of an interest in property, evidences of debts, leases, an undivided interest in a loan, rights of way, and interests in trusts.

**52.1(2)** *Corporate activities not creating taxability.* a. Public Law 86-272, 15 U.S.C.A., Sections 381-385, in general prohibits any state from imposing an income tax on income derived within the state from interstate commerce if the only business activity within the state consists of the solicitation of orders of tangible personal property by or on behalf of a corporation by its employees or representatives. Such orders must be sent outside the state for approval or rejection and, if approved, must be filled by shipment or

delivery from a point outside the state to be within the purview of Public Law 86-272. Public Law 86-272 does not extend to those corporations which sell services, real estate, or intangibles in more than one state or to domestic corporations. For example, Public Law 86-272 does not extend to brokers or manufacturers' representatives or other persons or entities selling products for another person or entity.

If the only activities in Iowa of a foreign corporation selling tangible personal property are those of the type described in the noninclusive listing below, the corporation is protected from the Iowa corporation income tax, law by Public Law 86-272.

(1) The free distribution by salespersons of product samples, brochures, and catalogues which explain the use of or laud the product, or both.

(2) The lease or ownership of motor vehicles for use by salespersons in soliciting orders.

(3) Salespersons' negotiation of a price for a product, subject to approval or rejection outside the taxing state of such negotiated price and solicited order.

(4) Demonstration by salesperson, prior to the sale, of how the corporation's product works.

(5) The placement of advertising in newspapers, radio, and television.

(6) Delivery of goods to customers by foreign corporation in its own or leased vehicles from a point outside the taxing state. Delivery does not include nonimmune activities, such as picking up damaged goods.

(7) Collection of state or local-option sales taxes or state use taxes from customers.

(8) Audit of inventory levels by salespersons to determine if corporation's customer needs more inventory.

(9) Recruitment, training, evaluation, and management of salespersons pertaining to solicitation of orders.

(10) Salespersons' intervention/mediation in credit disputes between customers and non-Iowa located corporate departments.

(11) Use of hotel rooms and homes for sales-related meetings pertaining to solicitation of orders.

(12) Salespersons' assistance to wholesalers in obtaining suitable displays for products at retail stores.

(13) Salespersons' furnishing of display racks to retailers.

(14) Salespersons' advice to retailers on the art of displaying goods to the public.

(15) Rental of hotel rooms for short-term display of products.

(16) Mere forwarding of customer questions, concerns, or problems by salespersons to non-Iowa locations.

b. For tax years beginning on or after January 1, 1996, a foreign corporation will not be considered doing business in this state or deriving income from sources within this state if its only activities within this state are one or more of the following activities:

(1) Holding meetings of the board of directors or shareholders, or holiday parties, or employee appreciation dinners.

(2) Maintaining bank accounts.

(3) Borrowing money, with or without security.

(4) Utilizing Iowa courts for litigation.

(5) Owning and controlling a subsidiary corporation which is incorporated in or which is transacting business within this state where the holding or parent company has no physical presence in the state as that presence relates to the ownership or control of the subsidiary.

(6) Recruiting personnel where hiring occurs outside the state.

c. For tax years beginning on or after January 1, 1997, a foreign corporation will not be considered doing business in this state or deriving income from sources within this state if its only activities within this state, in addition to the activities listed in paragraph "b" above, are training its employees or educating its employees, or using facilities in this state for this purpose.

**52.1(3)** *Corporate activities creating taxability.* "Solicitation of orders" within Public Law 86-272 is limited to those activities which explicitly or implicitly propose a sale or which are entirely ancillary to requests for purchases. Activities that are entirely ancillary to a request for purchases are ones that serve no independent business function apart from their connection to the soliciting of orders. An activity that is not ancillary to requests for purchases is one that a corporation (taxpayer) has a reason to do anyway whether or not it chooses to allocate it to its sales force operating in Iowa (such as repair, installation, service type activities, collection on accounts, etc.). Activities that take place after a sale ordinarily will not be entirely ancillary to a request for purchases and, therefore, ordinarily will not be considered in "solicitation of orders." *Wisconsin Department of Revenue v. William Wrigley, Jr. Company*, 60 U.S.L.W. 4622, 505 U.S. . . . , 120 L.Ed.2d 174, 112 S.Ct. 2447 (1992).

De minimis activities which are not "solicitation of orders" are protected under Public Law 86-272. Whether in-state nonsolicitation activities are sufficiently de minimis to avoid loss of tax immunity depends upon whether those activities establish only a trivial additional connection with the taxing state. Whether a corporation's nonsolicitation

in-state activities are de minimis should not be decided solely by the quantity of one type of such activity but, rather, all types of nonsolicitation activities of the taxpayer should be considered in their totality. *Wisconsin v. Wrigley*, 60 U.S.L.W. 4622, 505 U.S. . . . , 120 L.Ed.2d 174, 112 S.Ct. 2447 (1992). Frequency of the activity may be relevant, but an isolated activity is not invariably trivial. The mere fact that an activity involves small amounts of money or property does not invariably mean it is trivial.

If a foreign corporation has greater than a de minimis amount of Iowa nonsolicitation activity which includes activity of the types described in the noninclusive listing below, whether done by the salesperson, other employee, or other representative, it is not immunized from the Iowa corporation income tax by Public Law 86-272.

a. Installation or assembly of the corporate product.

b. Ownership or lease of real estate by corporation.

c. Solicitation of orders for, or sale of, services or real estate.

d. Sale of tangible personal property (as opposed to solicitation of orders) or performance of services within Iowa.

e. Maintenance of a stock of inventory.

f. Existence of an office or other business location.

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g. Managerial activities pertaining to nonsolicitation activities.

h. Collections on regular or delinquent accounts.

i. Technical assistance and training given after the sale to purchaser and user of corporate products.

j. The repair or replacement of faulty or damaged goods.

k. The pickup of damaged, obsolete, or returned merchandise from purchaser or user.

l. Rectification of or assistance in rectifying any product complaints, shipping complaints, etc., if more is involved than relaying complaints to a non-Iowa location.

m. Delivery of corporate merchandise inventory to corporation's distributors or dealers on consignment.

n. Maintenance of personal property which is not related to solicitation of orders.

o. Participation in recruitment, training, monitoring, or approval of servicing distributors, dealers, or others where purchasers of corporation's products can have such products serviced or repaired.

p. Inspection or verification of faulty or damaged goods.

q. Inspection of the customer's installation of the corporate product.

r. Research.

s. Salespersons' use of part of their homes or other places as an office if the corporation pays for such use:

t. The use of samples for replacement or sale; storage of such samples at home or in rented space.

u. Removal of old or defective products.

v. Verification of the destruction of damaged merchandise.

w. Independent contractors, agents, brokers, representatives and other individuals or entities who act on behalf of or at the direction of the corporation (taxpayer) and who do non-de minimis amounts of nonsolicitation activities remove the corporation from the protection of Public Law 86-272. However, the maintenance of an office in Iowa or the making of sales in Iowa by independent contractors does not remove the corporation from the protection of Public Law 86-272. The term "independent contractors" means commission agents, brokers, or other independent contractors who are engaged in selling or soliciting orders for the sale of tangible personal property or perform other services for more than one principal and who hold themselves out as such in the regular course of their business activities. If a person is subject to the direct control of the foreign corporation that person may not qualify as an independent contractor.

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**52.1(4)** *Taxation of corporations having only intangible property located or having a situs in Iowa.* For tax years beginning on or after January 1, 1995, corporations whose only connection with Iowa is their ownership of intangible property located or having a situs in Iowa are subject to Iowa income tax and must file an Iowa income tax return. Intangible property is located or has a situs in Iowa if the corporation's commercial domicile is in Iowa and the intangible property has not become an integral part of some business activity occurring regularly within or without Iowa. Regardless of whether the corporation's commercial domicile is in or out of Iowa, intangible property is located or has a situs in Iowa if the intangible property has become an integral part of some business activity occurring regularly in Iowa. *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993), cent. denied, 114 S.Ct. 550 (1993); *Arizona Tractor Company v. Arizona State Tax Commission*, 115 Ariz. 602, 566 P.2d 1348 (Ariz. App. 1977). In the event that the intangible property interest is a general or limited partnership interest, the location or situs of that partnership interest is the places) where the partnership conducts business. *Arizona Tractor Company v. Arizona State Tax Commission*, supra.

The following nonexclusive examples illustrate how this subrule applies:

EXAMPLE 1: A, a corporation with a commercial domicile in State X, has a limited partnership interest in a partnership which does a regular business in Iowa. A has no physical presence in Iowa and has no other contact with Iowa. A's interest in the limited partnership is intangible personal property. A is required to file an Iowa income tax return

because A's intangible personal property limited partnership interest has a business situs in Iowa. *Arizona Tractor Company v. Arizona State Tax Commission*, supra.

EXAMPLE 2: B, a corporation with a commercial domicile in State X, owns stock in a subsidiary corporation doing business regularly in Iowa. B has no physical presence in Iowa and has no other contact with Iowa. B controls the subsidiary and has a unitary relationship with it. B pledged the subsidiary stock to secure a line of credit from a bank and used the loaned funds in B's business. Under these circumstances, the subsidiary stock is not an integral part of the subsidiary's business and, therefore, the stock does not have a location or situs in Iowa. Accordingly, B is not required to file an Iowa income tax return as a result of any dividends received by B or capital gains received by B from the sale of the stock. *McNamara v. George Engine Company, Inc.*, 519 So.2d 217 (La. App. 1988).

EXAMPLE 3: C, a corporation with a commercial domicile in State X, owns trademarks and trade names which it, by license agreements, allows other corporations to use. Some of those other corporations do business in Iowa. The trademarks and trade names are used by these other corporations at their Iowa stores in connection with their business activities at those stores. C has no physical presence in Iowa and has no other contact with Iowa. C is paid royalties of 1 percent of net sales of the licensed products or services. C is required to file an Iowa income tax return because C's intangible property interests in the trademarks and trade names have situses in Iowa. *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993), cent. denied, 114 S.Ct. 550 (1993).

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EXAMPLE 4: D, a corporation with a commercial domicile in Iowa, is a holding company which does not sell any tangible personal property or sell any business service but which does own the stock of five subsidiaries, all of which do business outside of Iowa. D has no physical presence outside of Iowa and has no other contact outside of Iowa. D has a unitary relationship with each subsidiary. Under these circumstances, the stock is not an integral part of each subsidiary's business so the stock does not have a location or situs outside of Iowa. The location or situs of the stock is in Iowa because D's commercial domicile is in Iowa. Accordingly, all of the dividends from the stock paid to D and any capital gains incurred as a result of D's sale of the stock are wholly taxed by Iowa.

EXAMPLE 5: E, a corporation with a commercial domicile in Iowa, owns trademarks and trade names which it, by license agreements, allows other corporations, located outside of Iowa, to use. The trademarks and trade names are used by these other corporations at their non-Iowa stores in connection with their business activities at those stores. E has no physical presence outside of Iowa and has no other contact outside of Iowa. E has business activities in Iowa. The fees and royalties paid to E are part of E's unitary business income. Under these circumstances, E is entitled to apportion its net income within and without Iowa because E's intangible property interests in the trademarks and trade names have situses outside of Iowa and E has business activities in Iowa.

EXAMPLE 6: F, a corporation with a commercial domicile in State X, owns all of the stock of a subsidiary

corporation doing business in Iowa. F has no physical presence in Iowa and no other contact with Iowa. F loans funds to the subsidiary which the subsidiary uses in its Iowa business. Under these circumstances, the interest bearing asset is not an integral part of the subsidiary's business and, therefore, that intangible asset does not have a location or situs in Iowa. Accordingly, F is not required to file an Iowa income tax return. *Beidler v. South Carolina Tax Commission*, 282 U.S. 1, 75 L.Ed. 131, 51 S.Ct. 54 (1930).

EXAMPLE 7: G, a corporation with a commercial domicile in State X, earns fees from the licensing of custom computer software. G has no physical presence in Iowa and no other contact with Iowa. G licenses the software to other corporations which do business in Iowa and which use the software in that business in Iowa. Under these circumstances, regardless whether the fees constitute royalties or something else, the license fees are earned from intangible personal property with a location or situs in Iowa. Accordingly, G is required to file an Iowa income tax return.

EXAMPLE 8: H, a corporation with a commercial domicile in State X, has no physical presence in Iowa. H has entered into a contract with an independent contractor to solicit sales of G's magazines in Iowa. The independent contractor does business in Iowa and receives payment for the magazines and deposits the funds in an Iowa bank for H's account. H earns interest on this account. Under these circumstances which are H's only contact with Iowa, H's interest-bearing account is an integral part of business activity in Iowa. Accordingly, H is required to file an Iowa income tax return and include the interest income in the numerator of the business activity formula.

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**52.1(5)** *Taxation of "S" corporations, domestic international sales corporations and real estate investment trusts.* Certain corporations and other types of entities, which are taxable as corporations for federal purposes, may by federal election and qualification have a portion or all of their income taxable to the shareholders or the beneficiaries. Generally, the state of Iowa follows the federal provisions (with adjustments provided by Iowa law) for determining the amount and to whom the income is taxable. Examples of entities which may avail themselves of pass-through provision for taxation of at least part of their net income are real estate investment trusts, small business corporations electing to file under Sections 1371-1378 of the Internal Revenue Code, domestic international sales corporations as authorized under Sections 991-997 of the Internal Revenue Code, and certain types of cooperatives and regulated investment companies. The entity's portion of the net income which is taxable as corporation net income for federal purposes is generally also taxable as Iowa corporation income (with adjustments as provided by Iowa law) and the shareholders or beneficiaries will report on their Iowa returns their share of the organization's income reportable for federal purposes as shareholder income (with adjustments provided by Iowa law). Nonresident shareholders or beneficiaries are required to report their distributive share of said income reasonably attributable to Iowa sources. Schedules shall be filed with the individual's return showing the computation of the income attributable to Iowa sources and the computation of the nonresident taxpayer's distributive share thereof. Entities with a nonresident beneficiary or shareholder shall include a schedule in the return computing the amount of income as determined under 701—Chapter 54 of the rules.

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It will be the responsibility of the entity to make the apportionment of the income and supply the nonresident taxpayer with information regarding the nonresident taxpayer's Iowa taxable income.

For tax years beginning on or after January 1, 1995, S corporations which are subject to tax on built-in gains under Section 1374 of the Internal Revenue Code or passive investment income under Section 1375 of the Internal Revenue Code are subject to Iowa corporation income tax on this income to the extent received from business carried on in this state or from sources in this state.

a. The starting point for computing the Iowa tax on built-in gains is the amount of built-in gains subject to federal tax after considering the federal income limitation. The starting point for computing the capital gains subject to Iowa tax is the amount of capital gains subject to federal tax. The starting point for computing the passive investment income subject to Iowa income tax is the amount of passive investment income subject to federal tax. To the extent that any of the above three types of income exist for federal income tax purposes, they are combined for Iowa income tax purposes.

b. No adjustment is made to the above amounts for either 50 percent of federal income tax or Iowa corporation income tax deducted in computing the federal net income of the S corporation. The 50 percent of federal income tax and Iowa corporation income tax deducted in computing federal net income are adjustments to the Iowa net income which flows through to the shareholders.

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c. The allocation and apportionment rules of 701—Chapter 54 apply to nonresident shareholders if the S corporation is carrying on business within and without the state of Iowa.

d. Any net operating loss carry forward arising in a taxable year for which the corporation was a C corporation shall be allowed as a deduction against the net recognized built-in gain, capital gains, or passive investment income of the S corporation for the taxable year. For purposes of determining the amount of any such loss which may be carried to any of the 15 subsequent taxable years, after the year of the net operating loss, the amount of the net recognized built-in gains shall be treated as taxable income.

e. Except for estimated and other advance tax payments and any credit carryforward under Iowa code section 422.33 arising in a taxable year for which the corporation was a C corporation no credits shall be allowed against the built-in gains tax or the tax on capital gains or passive investment income.

For tax years beginning after 1996, Iowa recognizes the federal election to treat subsidiaries of a parent corporation that has elected S corporation status as "qualified subchapter S subsidiaries" (QSSSs). To the extent that, for federal income tax purposes, the incomes and expenses of the QSSSs are combined with the parent's income and expenses, they must be combined for Iowa tax purposes.

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**52.1(6)** *Exempted corporations and organizations filing requirements.* a. *Exempt status.* An organization that is exempt from federal income tax under Section 501 of the Internal Revenue Code, unless the exemption is denied under Section 501, 502, 503 or 504 of the Internal Revenue Code, is exempt from Iowa corporation income tax except as set forth in paragraph "e" of this subrule. The department may, if a question arises regarding the exempt status of an organization, request a copy of the federal determination letter.

b. *Information returns.* Every corporation shall file returns of information as provided by sections 422.15 and 422.16 and any regulations regarding information returns.

c. *Annual return.* An organization or association which is exempt from Iowa corporation income tax because it is exempt from federal income tax is not required to file an annual income tax return unless it is subject to the tax on unrelated business income. The organization shall inform the director in writing of any revocation of or change of exempt status by the Internal Revenue Service within 30 days after the federal determination.

d. *Tax on unrelated business income for tax years beginning prior to January 1, 1988.* Where a corporation or organization is subject to the federal income tax imposed by section 511 of the Internal Revenue Code on unrelated business income, the corporation or organization is not subject to Iowa corporation income tax on the unrelated business income. Opinion of the Attorney General, Griger to Craft, February 13, 1978.

e. *Tax on unrelated business income for tax years beginning on or after January 1, 1988.* A tax is imposed on the unrelated business income of corporations, associations, and organizations exempt from the general business tax on corporations by Iowa Code section 422.34, subsections 2 through 6, to the extent this income is subject to tax under the Internal Revenue Code. The exempt organization is also subject to the alternative minimum tax imposed by Iowa Code section 422.33(4).

The exempt corporation, association, or organization must file Form IA 1120, Iowa Corporation Income Tax Return, to report its income and complete Form IA 4626 if subject to the alternative minimum tax. The exempt organization must make estimated tax payments if its expected income tax liability for the year is $1,000 or more.

The tax return is due the last day of the fourth month following the last day of the tax year and may be extended for six months by filing Form IA 7004 prior to the due date. For tax years beginning on or after January 1, 1991, the tax return is due on the fifteenth day of the fifth month following close of the tax year and may be extended six months by filing Form IA 7004 prior to the due date.

The starting point for computing Iowa taxable income is federal taxable income as properly computed before deduction for net operating losses. Federal taxable income shall be adjusted as required in Iowa Code section 422.35.

If the activities which generate the unrelated business income are carried on partly within and partly without the

state, then the taxpayer should determine the portion of unrelated business income attributable to Iowa by the apportionment and allocation provisions of Iowa Code section 422.33.

The provisions of 701—Chapters 51, 52, 53, 54, 55 and 56 apply to the unrelated business income of organizations exempt from the general business tax on corporations.

**52.1(7)** *Income tax of corporations in liquidation.* When a corporation is in the process of liquidation, or in the hands of a receiver, the income tax returns must be made under oath or affirmation of the persons responsible for the conduct of the affairs of such corporations, and must be filed at the same time and in the same manner as required of other corporations.

**52.1(8)** *Income tax returns for corporations dissolved.* Corporations which have been dissolved during the income year must file income tax returns for the period prior to dissolution which has not already been covered by previous returns. Officers and directors are responsible for the filing of the returns and for the payment of taxes, if any, for the audit period provided by law.

Where a corporation dissolves and disposes of its assets without making provision for the payment of its accrued Iowa income tax, liability for the tax follows the assets so distributed and upon failure to secure the unpaid amount, suit to collect the tax may be instituted against the stockholders and other persons receiving the property, to the

extent of the property received, except bona fide purchasers or others as provided by law.

This rule is intended to implement Iowa Code sections 422.21, 422.32, 422.33 as amended by 1999 Iowa Acts, chapter 151, 422.34, 422.34A and 422.36.

**52.1(9)** *Income tax returns for corporations storing goods in an Iowa warehouse.* For tax years beginning on or after January 1, 2001, foreign corporations are not required to file income tax returns if their only activities in Iowa are the storage of goods for a period of 60 consecutive days or less in a warehouse for hire located in Iowa, provided that the foreign corporation transports or causes a carrier to transport such goods to that warehouse and that none of these goods are delivered or shipped to a purchaser in Iowa.

The following nonexclusive examples illustrate how this subrule applies:

EXAMPLE 1: A, a foreign corporation, stores goods in a warehouse for hire in Iowa for a period of 45 consecutive days. The goods are then delivered to a purchaser outside Iowa. If this is A's only activity in Iowa, A is not required to file an Iowa income tax return.

EXAMPLE 2: B, a foreign corporation, stores goods in a warehouse for hire in Iowa for a period of 75 consecutive days. The goods are then delivered to a purchaser outside Iowa. B is required to file an Iowa income tax return because the goods were stored in Iowa for more than 60 consecutive days.

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EXAMPLE 3: C, a foreign corporation, stores goods in a warehouse for hire in Iowa for a period of 30 consecutive days. One percent of these goods are shipped to a purchaser in Iowa, and the other 99 percent are shipped to a purchaser outside Iowa. C is required to file an Iowa income tax return because a portion of the goods were shipped to a purchaser in Iowa.

EXAMPLE 4: D, a foreign corporation, has retail stores in Iowa. D also stores goods in a warehouse for hire in Iowa for a period of 30 consecutive days. The goods are then delivered to a purchaser outside Iowa. D is required to file an Iowa income tax return because its Iowa activities are not limited to the storage of goods in a warehouse for hire in Iowa.

EXAMPLE 5: E, a foreign corporation, has goods delivered by a common carrier, F, into a warehouse for hire in Iowa. the goods are stored in the warehouse for a period of 40 consecutive days, and are then delivered to a purchaser outside Iowa. If this is E's only activity in Iowa, E is not required to file an Iowa income tax return. However, F is required to file an Iowa income tax return because it derives income from transportation operations in Iowa.

This rule is intended to implement Iowa Code section 422.21, 422.32, 422.33, 422.34, 422.34A and 422.36 as amended by 2001 Iowa Acts, House File 707.

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**52.1(10)** *Deferment of income for start-up companies.* For tax periods beginning on or after January 1, 2002, a business that qualifies as a "start-up" business can defer taxable income for the first three years that the business is in operation.

a. Definition of start-up business. A start-up business for purposes of this subrule does not include any of the following:

(1) An existing business locating in Iowa from another state.

(2) An existing business locating in Iowa from another location in Iowa.

(3) A newly created business which is the result of the merger of two or more businesses.

(4) A newly created subsidiary or new business of a corporation.

(5) A previously existing business which has been dissolved and reincorporated.

(6) An existing business operating under a different name and located in a different location.

(7) A newly created partnership owned by two or more of the same partners as an existing business and engaging in similar business activity as the existing business.

(8) A business entity that reorganizes or experiences a change in either the legal or trade name of the business.

(9) A joint venture.

b. Criteria for deferment of taxable income. In order to qualify for the deferment of taxable income for a start-up business, each of the following criteria must be met:

(1) The taxpayer is a business that is a wholly new start-up business beginning operations during the first tax year for which the deferment of taxable income is claimed.

(2) The business has its commercial domicile, as defined by Iowa Code section 422.32, in Iowa.

(3) The operations of the business are funded by at least 25 percent venture capital moneys. "Venture capital moneys" means an equity investment from an individual or a private seed and venture capital fund whose only business is investing in seed and venture capital opportunities. "Venture capital moneys" does not mean a loan or other nonequity financing from a person, financial institution or other entity.

(4) The taxpayer does not have any delinquent taxes or other debt outstanding and owing to the state of Iowa.

c. Request for deferment of income. A taxpayer must submit a request to the department for the deferment of

taxable income. The request must provide evidence that all of the criteria to qualify as a start-up business have been met. The request should be made as soon as possible after the close of the first tax year of the business. The request is to be filed with the Iowa Department of Revenue and Finance, Policy Section, Compliance Division, P.O. Box 10457, Des Moines, Iowa 50306-0457. Upon determination that the criteria have been met, the department will notify the taxpayer that the deferment of taxable income is approved. If the request for deferment of taxable income is denied, the taxpayer may file a protest within 60 days of the date of the letter denying the request for deferment of taxable income. The department's determination letter shall set forth the taxpayer's rights to protest the department's determination.

d. Filing of tax returns. If the request for deferment of taxable income is approved, taxable income for the first three years that the business is in operation is deferred. The taxpayer shall pay taxes on the deferred taxable income in five equal annual installments during the five tax years following the three years of deferment. Tax returns must be filed for each tax year in which the deferment is approved. If the taxpayer has a net loss during any tax year during the three-year deferment period, the loss may be applied to any deferred taxable income during that period. For purposes of assessing penalty and interest, the tax on any deferred income is not due and payable until the tax years in which the five equal annual installments are due and payable.

The following nonexclusive examples illustrate how this subrule applies:

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EXAMPLE 1: A qualifying start-up business reports Iowa taxable income of $1,000 in year one, $5,000 in year two and $10,000 in year three. The total tax deferred is $60 in year 1, $300 in year two and $600 in year three, or $960. The taxpayer shall pay $192 ($960 divided by 5) in deferred tax for each of the next five tax returns. No penalty or interest is due on the deferred annual tax of $192 if the returns for years four through eight are filed by the due date and the tax is timely paid. After the return for year three is filed, the department will issue a schedule to the qualifying business indicating that $192 of additional tax is due annually for years four through eight, and when the additional payments of $192 are due.

EXAMPLE 2: A qualifying start-up business reports an Iowa taxable loss of $10,000 in year one, a loss of $2,000 in year two and taxable income of $22,000 in year three. The losses for year one and year two can be netted against the income in year three, resulting in deferred taxable income of $10,000. The tax of $600 computed on income of $10,000 will be paid in five equal installments of $120 for the next five tax returns. No penalty or interest is due on the deferred annual tax of $120 if the returns for years four through eight are filed by the due date and the tax is timely paid. After the return for year three is filed, the department will issue a schedule to the qualifying business indicating that $120 of additional tax is due annually for years four through eight and when the additional payments of $120 are due.

This rule is intended to implement Iowa Code sections 422.21, 422.32, 422.33, 422.34, 422.34A and 422.36 and 2002 Iowa Acts, House File 2592.

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(Amended effective November 11, 1987; June 8, 1988; October 12, 1988; December 20, 1989; March 14, 1990; November 6, 1991; December 30, 1992; March 8, 1995; April 19, 1995; November 29, 1995; April 3, 1996; May 15, 1996; November 13, 1996; December 10, 1997; April 15, 1998; March 29, 2000; April 25, 2001; November 6, 2002.)

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**STATE-REG, NJ-TAXRPTR ¶14-017, REG. 18:7-1.9. DOING BUSINESS IN NEW JERSEY; DEFINITION AND RULES OF CONSTRUCTION.—**

New Jersey Regulation, **Reg. 18:7-1.9.—**

(a) The term "doing business" is used in a comprehensive sense and includes all activities which occupy the time or labor of men for profit.

1. Regardless of the nature of its activities, every corporation organized for profit and carrying out any of the purposes of its organization within the State shall be deemed to be "doing business" for the purposes of this Act.

2. In determining whether a corporation is "doing business," it is immaterial whether its activities result in a profit or a loss.

(b) Whether a foreign corporation is doing business in New Jersey is determined by the facts in each case. Consideration is given to such factors as:

1. The nature and extent of the activities of the corporation in New Jersey;

2. The location of its offices and other places of business;

3. The continuity, frequency and regularity of the activities of the corporation in New Jersey;

4. The employment in New Jersey of agents, officers and employees;

5. The location of the actual seat of management or control of the corporation.

*Example*

Foreign corporation R holds trademarks that were assigned to it by its parent corporation. R receives fees as a result of licensing those trademarks to certain New Jersey companies for use in New Jersey. R is subject to the corporation business tax on its apportioned income as a result of its trademark licensing activities.

(c) A foreign corporation shall not be deemed to be doing business or employing or owning capital or property in this State for the purposes of the Act by reason of the following:

1. The maintenance of cash balances with banks or trust companies in New Jersey;

2. The ownership of shares of stock or securities kept in New Jersey in a safe deposit box, safe, vault or other receptacle rented for the purpose, or pledged as collateral security, or deposited with one or more banks or trust companies, or brokers who are members of a recognized security exchange, in safekeeping or custody accounts;

3. The taking of any action by any such bank or trust company or broker which is incidental to the rendering of safekeeping or custodian service to such corporation.

4. Any combination of the foregoing activities.

(d) If the only business activity of a foreign corporation within New Jersey consists of the solicitation of orders for sales of its tangible personal property, which orders are to be sent outside the State for acceptance or rejection and, if accepted, are to be filled by shipment or delivery from a point outside the State, then such corporation is doing business in New Jersey and is subject to the tax. Unless it has additional contacts with New Jersey, however, it will not be liable for any tax measured by the income of the corporation. (See P.L. 86-272, U.S.C. §381). The corporation will be liable for filing a return and payment of the minimum tax.

1. For the in-State activities of the foreign corporation to immunize the corporation from taxation measured by income, such activities must be limited solely to:

i. Speech or conduct that explicitly or implicitly invites an order; and

ii. Activities that neither explicitly nor implicitly invite an order but that are entirely ancillary to requests for an order.

2. Examples of additional activities or contacts with New Jersey that will subject a corporation to the tax based on or measured by income are:

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i. Repairs, maintenance, and installations;

ii. Collection or repossession activities;

iii. Credit investigations;

iv. Personnel courses or lectures;

v. Technical assistance;

vi. Customer complaint resolution if the sole purpose is not to ingratiate sales personnel with the customer;

vii. Approving or accepting orders or securing deposits on sales;

viii. Acquiring personnel for other than solicitation activities;

ix. Maintaining a display at a single location in excess of two weeks during the tax year;

x Carrying samples for sale, exchange or distribution in any manner for consideration or other value;

xi Owning, leasing, or maintaining in-state facilities such as a warehouse or answering service; and

xii. Consignment of personal property.

3. Examples of additional activities which, together with the solicitation activities described in (d)1 above will not subject a corporation to tax based on or measured by income are:

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i. Solicitation of orders through advertising;

ii. Carrying samples for display or distribution without charge;

iii. Providing automobiles, owned or leased, registered or not registered in New Jersey to sales personnel for their use in conducting protected activities;

iv. Checking customer inventories without charge;

v. Maintaining a display at a single location for less than two weeks during the tax year;

vi. Recruitment, training, or evaluating of sales personnel;

vii. A sales employee's in-home work space that is not paid for by the company; and

viii. Mediating customer complaints if just to ingratiate sales personnel with the customer.

(e) Independent contractors may solicit or make sales or maintain an office without subjecting a company to liability for tax based on or measured by income. Sales representatives who represent a single principal would not be considered independent contractors. A corporation would be subject to income-based tax if the independent contractor maintained a stock of goods in the State under consignment or for purposes other than for display and solicitation.

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*Example*

Foreign corporation L, represented in New Jersey by a foreign independent contractor, licensing software to New Jersey businesses. L receives fees from New Jersey companies for licensing the software. L is subject to the corporation business tax on its apportioned income. (Amended April 18, 1994, April 3, 1995; November 4, 1996.)

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**STATE-REG, NC-TAXRPTR ¶14-004, NCAC RULE, SEC. 17: O5C.0102. DOING BUSINESS DEFINED.—**

North Carolina Regulation, **NCAC Rule, Sec. 17: O5C.0102.—**

(a) For income tax purposes, the term "doing business" means the operation of any business enterprise or activity in North Carolina for economic gain, including, but not limited to, the following:

(1) the maintenance of an office or other place of business in North Carolina;

(2) the maintenance in North Carolina of an inventory of merchandise or material for sale, distribution or manufacture, regardless of whether kept on the premises of the taxpayer or in a public or rented warehouse;

(3) the selling or distributing of merchandise to customers in North Carolina directly from a company-owned or operated vehicle when title to the merchandise is transferred from the seller or distributor to the customer at the time of the sale or distribution;

(4) the rendering of a service to clients or customers in North Carolina by agents or employees of a foreign corporation;

(5) the owning, renting, or operating of business or income-producing property in North Carolina including, but not limited to, the following:

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(A) Realty;

(B) Tangible personal property;

(C) Trademarks, tradenames, franchise rights, computer programs, copyrights, patented processes, licenses.

(b) Corporations who are partners in a partnership or joint venture operating in North Carolina are considered to be "doing business".

(c) "Doing business" by an interstate motor carrier is defined as the performance of any of the following business activities in North Carolina:

(1) The maintenance of an office in the State;

(2) The operation of a terminal or other place of business in the State;

(3) Having an employee working out of the office or terminal of another company;

(4) Dropping off or gathering up shipments in the State.

(Added February 1, 1976; amended November 2, 1992; January 1, 1994.)

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## ADMN-RUL, MA-TAXRPTR, ¶360-143, DEPARTMENT OF REVENUE DIRECTIVE 96-2, JULY 3 1996

**Department of Revenue Directive 96-2**, July 3 1996

**Creation of Nexus Through the In-State Ownership and Use of Intangible Property**

*Issue*

Under what circumstances will the in-state ownership and use of intangible property subject a foreign corporation to the corporate excise?

*Directive*

A foreign corporation's intangible property used within Massachusetts will subject that corporation to the corporate excise when:

1. The intangible property generates, or is otherwise a source of, gross receipts within the state for the corporation, including through a licensure or franchise; and

2. The activity through which the corporation obtains such gross receipts from its intangible property is purposeful (e.g., a contract with an in-state company); and

3. The corporation's presence within the state, as indicated by its intangible property and its activities with respect to that property, is more than de minimis.

## *Appendix L*

*Explanation*

Under G.L. c. 63, section 39, a foreign corporation is subject to the corporate excise when, inter alia, it does business in Massachusetts, or owns or uses any part or all of its capital, plant, or any other property in the state. The Commissioner construes this provision to the full extent permitted by the Constitution and laws of the United States.

The definition of intangible property generally includes, but is not limited to, copyrights, patents, trademarks, trade names, trade secrets, service marks, and know-how. However, for purposes of this directive, the Commissioner will treat a license of canned software, transferred on a tangible medium to be used for any purpose other than commercial reproduction, as the sale of tangible personal property, not the license of intangible property.

A foreign corporation whose in-state activity is described in G.L. c. 63, section 39 is not subject to the Massachusetts corporate excise if such in-state activity is within the confines of Public Law 86-272 (15 U.S.C. section 381 et seq.) Public Law 86-272 precludes the imposition of a corporate tax measured by net income when a foreign corporation's sole activity in Massachusetts is solicitation of sales of tangible personal property, provided certain conditions are met. For example, Public Law 86-272 could potentially apply to a foreign corporation's solicitation of sales in Massachusetts of tangible personal property which contains intangible property (such as books, recordings, or canned software). In contrast, the focus of this directive is transactions in which a foreign corporation derives gross receipts from intangible

property that is licensed or otherwise transferred for continuing commercial exploitation in the state. These latter transactions are not protected by Public Law 86-272.

*Examples*

The following examples illustrate the application of this directive. In Examples 1-3, it is presumed that the foreign corporation's presence in Massachusetts, as indicated by its intangible property and its activities with respect to that property, is more than de minimis. Moreover, in Examples 1-3 it is presumed that the foreign corporation does not otherwise transact business or own property in the state.

*Example 1*

Dress Shop, a Delaware corporation located in Wisconsin, manufactures and sells girls' clothing under the name Tinker Bell. In Year 1, Dress Shop licenses the name Tinker Bell to Girl Towne, a Massachusetts company, for use in connection with the sale of clothing produced by Girl Towne in Massachusetts. Pursuant to the contract entered into between Dress Shop and Girl Towne, Girl Towne is to pay Dress Shop a royalty of 2% on the sale of every item of clothing sold under the Tinker Bell name. Girl Towne makes sales under the Tinker Bell name in Massachusetts during Year 1 and makes the corresponding royalty payments to Dress Shop, as required. Dress shop has nexus with Massachusetts in Year 1.

## *Appendix L*

*Example 2*

Motor Way, a Delaware corporation located in Alabama, develops the technology for a new low-weight motor scooter and patents this technology. In Year 2, Motor Way licenses its patented technology to Speed Rider, a Massachusetts company, for use in connection with the manufacture and sale of scooters in Massachusetts. Pursuant to the contract entered into between Motor Way and Speed Rider, Speed Rider is to pay Motor Way an upfront fee for the right to make use of Motor Way's patented technology, and a royalty of 4% on the sales of every scooter that Speed Rider and sells using this technology. Speed Rider manufactures scooters using the Motor Way technology in Year 2, and sells these scooters in Massachusetts during that same year. In addition, Speed Rider makes the corresponding royalty payments to Motor Way for Year 2, as required. Motor Way has nexus with Massachusetts in Year 2.

*Example 3*

Ginzu Ltd. is a fast-food franchiser, incorporated in Delaware and located in New Jersey. In Year 3, Ginzu Ltd. franchises the rights to one of its "Ginzu Gardens" fast-food restaurants to a franchisee, John Cook, a New Hampshire resident, for a location in Massachusetts. The terms of the franchise agreement both permit and require Mr. Cook to use the various items of intangible property owned by Ginzu Ltd. (e.g., the name "Ginzu Gardens", certain service marks, a patented food process, trade secrets, and know-how). In addition, the terms of the franchise agreement require Mr. Cook to pay Ginzu Ltd. a monthly franchise fee, as well

as a royalty charge of 6% of the sales proceeds received by the Massachusetts' restaurant, Ginzu Gardens. Mr. Cook makes such payments to Ginzu Ltd. during Year 3, as required. Ginzu Ltd. has nexus with Massachusetts in Year 3.

*Example 4*

Golf Time is a corporation, incorporated in South Carolina and located there. Golf Time is the creator of "cold day" golf clubs. "Cold day" golf clubs have grips that emit warmth when squeezed, since they are specially treated with Golf Time's "heat-grip" technology. Golf Time has patented its "heat grip" technology, and obtained registered trademarks for each of the terms "cold day" and "heat-grip". Golf Time solicits sales of its "cold day" golf clubs in Massachusetts, touting the merits of its "heat grip" technology. Golf Time's activities result in significant sales of "cold day" golf clubs in Massachusetts. Golf Time engages in no other business activity with respect to Massachusetts. Assuming Golf Time's Massachusetts activities are protected by Public Law 86-272, Golf Time will not be subject to the corporate excise for the years in question.

*Effective Date*

The principles set forth in this directive will apply to taxable years beginning on or after January 1, 1996.

[See ¶10-205.]